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LETTERS OF TRANSMITTAL

JANUARY 22, 1982.

To the Members of the Joint Economic Committee:

I am pleased to transmit a volume of essays entitled "U.S. International Economic Policy in the 1980's." The volume was prepared for the Joint Economic Committee under the direction of Alfred Reifman, Senior Specialist in International Economics of the Congressional Research Service. CRS provided 10 essays and I have added an essay by James K. Galbraith, executive director of the Joint Economic Committee.

The project was coordinated for the committee by James K. Galbraith, executive director, and by Richard F. Kaufman, assistant director/general counsel.

Sincerely,

HENRY S. REUSS,
Chairman, Joint Economic Committee.

JANUARY 8, 1982.

Hon. HENRY S. REUSS,
Chairman, Joint Economic Committee,
Congress of the United States,
Washington, D.C.

DEAR MR. CHAIRMAN: I am pleased to transmit a volume of essays entitled "U.S. International Economic Policy in the 1980's." The volume was prepared for the Joint Economic Committee under the direction of Alfred Reifman, Senior Specialist in International Economics of the Congressional Research Service.

The views expressed in these essays are those of the authors and do not necessarily reflect the views of the Joint Economic Committee or of any member.

Sincerely,

JAMES K. GALBRAITH,
Executive Director, Joint Economic Committee.

DECEMBER 11, 1981.

Hon. HENRY S. REUSS,
Chairman, Joint Economic Committee,
Congress of the United States,
Washington, D.C.

DEAR MR. CHAIRMAN: I am pleased to transmit a collection of 10 studies of "U.S. International Economic Policy in the 1980's."

The collection is divided into four parts:

(1) *General*, which contains an Overview treating the major issues for U.S. policy, and a Summary of the detailed studies which follow.

(2) *Trade and Investment*, which includes an essay on United States-Japan economic relations plus three papers on issues in foreign trade and investment.

(3) *Finance*, which has studies of the evolution of the international monetary system and the debt problem of developing countries.

(4) *Developing Countries*, which has a study of the issues of foreign aid and trade with developing countries and another on the lessons to be learned from the success of the newly industrializing countries.

This volume was prepared under the general direction of Alfred Reifman, Senior Specialist in International Economics of the Congressional Research Service. He and Albert Mayio, a CRS economic consultant, reviewed and edited the essays. Richard F. Kaufman of the staff of the Joint Economic Committee helped to plan the volume.

Sincerely,

GILBERT GUDE,
Director, Congressional Research Service,
Library of Congress.

FOREWORD

By Chairman Henry S. Reuss

The essays on "U.S. International Economic Policy in the 1980's" provide a comprehensive discussion of the major issues in international economic policy today. One common theme runs through all the essays: the importance to world economic development of U.S. domestic economic policy.

In relative terms, the impact of the United States on the world economy has decreased since the end of World War II, while that of Europe, Japan and, in the 1970's, the Middle East has increased. Nevertheless, the United States remains a preponderant force in the world economy.

Accounting for one-quarter of the world's production and 40 percent of the GNP of the non-Communist industrial countries, the United States is still the only economic superpower. Second place is well behind: the U.S.S.R. has 12 percent of world output, and, among the non-Communist countries, Japan ranks second with 10 percent of world output. Even these numbers understate the global influence of the United States. They do not reflect our dominant role in science and technology, international investment and foreign aid.

While it is no longer true that when the United States sneezes, the rest of the world catches pneumonia, the health of the international economy depends to a considerable degree upon the health of the U.S. economy. A depressed U.S. economy depresses the world economy; an inflationary U.S. economy exports inflation to the rest of the world. Worse than either of these afflictions is their combination, stagnation and inflation—stagflation.

In a world economy beset by stagflation, there are pressures forcing countries to retreat to trade protectionism. The result could be a reduction in world trade, which since World War II has been a major engine of worldwide economic growth. Stagflation reduces foreign aid and foreign private investment. Stagflation means increased unemployment, erosion of savings and increases human misery everywhere. Finally, stagflation breeds disillusion with the democratic economic and political system and fosters the rise of political extremism.

Since the advent of the Reagan administration, U.S. economic policy has been aggravating rather than ameliorating the difficulties faced by this country and the world at large. It has done this by attempting to pursue aims that are inconsistent with each other. Fiscal restraint, in the form of cuts in Federal spending on social programs, has been overwhelmed by proposed increases in military outlays and a huge cut in taxes. The aim of a balanced budget has been replaced by the prospect of enormous, sustained, and widening governmental deficits. A draconian program of monetary restraint has been imposed by the Federal Reserve at the administration's urging. The result has been a persistent increase in interest rates, and now a brutal recession.

There is no indication of the investment boom that was a prime feature of the administration's economic scenario in its early days. Far from galvanizing investment in real capital, the administration's policy of high interest rates and recession has crippled the U.S. housing and automobile industries, made it impossible for most Americans to buy or sell a home, and put many savings and loan associations on the road to insolvency.

While short-term interest rates have eased recently, in real terms (i.e., after allowing for inflation) they are still unacceptably high. High real U.S. interest rates force high interest rates abroad and impede economic growth there, as does a declining U.S. economy. By attracting funds to the United States, the high U.S. interest rates could force a sharp deterioration in U.S. trade performance, weakening exports and helping imports make sharp inroads in the U.S. market. This will continue in 1982 and will add to the current U.S. recession and unemployment. And if the recession abates in 1982 as some predict, interest rates are likely to be pushed even higher unless current policies are changed.

The impact of high interest rates on the nonoil developing countries is nothing less than catastrophic. This additional burden comes at a time when the developing countries are coping with weak markets for their exports and deteriorating terms of trade (as their export prices are outrun by the cost of their imports).

Our national economic policies are the key to the health of the world economy. These policies must, accordingly, be conceived and carried out with due account for their repercussions on the world economy. A national economic policy which fails to do this is itself doomed to failure.

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GENERAL

OVERVIEW OF MAJOR POLICY ISSUES

By Alfred Reifman*

The major shift in domestic economic policies promised by the Reagan Administration was well underway by the autumn of 1981. The shift was designed to arrest inflation, raise productivity, and enhance the nation's security. Political and economic developments abroad, however, can interfere with the achievement of these objectives as the OPEC oil shocks of the 1970's abundantly demonstrate. Sound international economic policies should help avert, or at least limit, the impact of future external shocks to the U.S. economy. Moreover, sound foreign economic policies of the United States and its major economic partners can enhance world and U.S. economic health.

The essays in this volume deal with the major world economic problems under three major headings: foreign trade and investment, international finance, and developing countries. This essay focuses on policy issues in these fields and presents a perspective from which to view the individual essays that follow.

One common theme runs through our review of these areas: sound domestic economic policies—not foreign economic policies—are the key to a healthy economy at home and abroad, and are critical to the management of most world economic problems. The international economic system is strong and resilient. The major single problem now facing it is recession or, at best, slow economic growth and high inflation in the industrial countries, particularly the United States which exerts a powerful influence on the world economy.

A. Trade

1. *General.*—International trade and investment have been the most dynamic elements in the unprecedented world economic growth since the end of World War II. The trade of the industrial countries has grown almost twice as fast as their production; foreign direct investment has grown much faster than total investment.

Two main policies have promoted these results: the pursuit of full employment and of a liberal international economic order. These policies have made the world economy more productive and have averted a return to the nationalistic, protectionist policies of the thirties which were responsible for spreading and deepening the Great Depression.

The United States consistently ran a foreign trade surplus—exporting more merchandise than it imports—for the first 71 years in this

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century. Since 1971, every year but two (1973 and 1975) has seen a deficit in merchandise trade. In the last several years the deficits have been very large—running between $20 billion and $34 billion a year. The outlook is for sharp increases in the deficits over the next two years.

In any year the trade deficit can be explained by one or more specific factors—U.S. inflation, the hike in the price of imported oil, more robust economic expansion in the United States than abroad, the shift in consumer demand to fuel-efficient automobiles, a change in exchange rates. But the persistence of the deficit has raised more basic concerns about a general decline in U.S. competitiveness and U.S. economic leadership, and has stimulated a search for specific solutions.

Concern about deficits in merchandise trade can be misplaced. We should be concerned about high inflation and low growth of productivity because they are injurious to U.S. welfare, but not because solving these problems will necessarily eliminate the trade deficit. Solving these problems will clearly strengthen the economy, but the trade deficit might nevertheless persist. More specifically, an improvement in U.S. productivity, a commonly recommended panacea, is no solution to the foreign trade problem if labor insists on higher wages and industry on higher profits, in effect consuming the fruits of the growth of productivity.

The United States could well run a trade deficit for the foreseeable future. The United States is now a mature creditor country. U.S. income from foreign investment is huge—some $35 billion, net, in 1981—and growing. Such earnings strengthen the dollar. A strong dollar inhibits exports and induces imports. While varying from year to year the trend toward large and growing deficits in foreign trade in goods may well persist for the foreseeable future. (The persistence of a deficit on merchandise trade account could be, as it has been, consistent with equilibrium or even surplus in the overall U.S. balance of payments on current account, a more significant measure than the trade account. The current account covers exports and imports of goods, services including investment income, military transactions and a variety of unilateral transactions such as private gifts to foreigners as well as merchandise trade.)

Because the dollar has been abnormally strong in 1981, and inflation here has been higher than inflation in our major competitors, Germany and Japan, the competitive position of U.S. manufactured products has deteriorated sharply. The result is likely to be a considerable worsening in the U.S. trade balance in 1982 and 1983, causing increased unemployment and raising pressure for import protection, especially against Japan, whose surplus in trade with the United States, already large, could become much larger.

In dealing with the new situation it is well to keep in mind certain basic considerations:

> An especially large trade deficit is likely to be transitory, yielding to a depreciation of the dollar, reduced U.S. inflation, lower U.S. interest rates, and vigorous economic expansion in our foreign markets. But, even with a healthy domestic economy, and particularly a fairly stable price level, the United States will probably continue to run a deficit in merchandise trade for at least the next few years.

A significant resort to increased protectionism could be self-defeating, since it would arrest and reverse the post-war movement toward lowered government barriers to trade. This movement led by the United States, is based on the argument that foreign trade is healthy, that it has an impact on our economy comparable to investment in machinery or improvement in technology. Foreign trade raises U.S. productivity by permitting and inducing U.S. labor and capital to shift from industries with low profits and low wages to those with higher profits and higher wages. We import goods that are available more cheaply abroad than at home, freeing our capital and workers to produce goods in which we have a comparative advantage.

This, in effect, amounts to an increase in productivity which may at times cause temporary unemployment—much as the installation of a new machine or a new product may create temporary unemployment. Is this sufficient reason for restricting imports? We would not normally prevent the introduction of machinery which displaces coal miners; we would meet the problems of unemployment in other ways. A comparable policy might well continue to be followed in meeting domestic problems caused by imports.

Normally foreign trade has little impact on the overall level of U.S. employment, or unemployment, except in the short-run. Jobs lost in one industry are usually quickly made up in another, and at higher real wages. Of course, a sudden spurt in imports may create large unemployment in one industry but this increase usually is a very small addition to the nation's unemployed and is likely to be temporary as increased exports create other jobs. Yet unemployment, even if temporary, has real national and personal costs, economic and human. All modern governments have policies to spread such costs over the entire society rather than let them focus capriciously on a few sectors of society.

The availability of imports reduces domestic inflationary pressures. Such an anti-inflationary weapon is especially important in today's economy—here and abroad.

With the completion of the Multilateral Trade Negotiation in 1979, the major trade issues on the horizon are in specific industries—autos, steel and textiles—and in trade with Japan and Communist countries. These are considered briefly below.

2. *Automobile imports.*—Imports of automobiles have been increasing steadily over the 1970's. They now take one-quarter of the U.S. automobile market. The recent increase in the foreign share of the U.S. market, however, is largely attributable to a shrinking of the total new car market, not to a bulge in imports, which rose only 2.8 percent from 1979 to 1980.

In November 1980, the U.S. International Trade Commission determined that while imports were an important cause of the problems of the U.S. auto industry, a sluggish U.S. economy, high interest rates and high costs of U.S. cars were more important. Import protection was denied. On May 21, 1981, after pressure from the U.S. Administration and the Congress, Japanese auto makers agreed with their government to reduce exports of passenger cars to the United States by 7.7 percent from the 1980 level (or by roughly 140,000 units) during the year ending March 1982.

The cut in Japanese auto exports will meet only a small part of the problem of the U.S. industry. As of December 1981, some 210,000 auto workers were on indefinite lay-off (the peak was 250,000 in August 1980). A reasonable estimate is that the cut-back in Japanese exports would increase U.S. employment by at most 10,000 jobs in the auto industry and 32,000 economy-wide. (The U.S. labor force in 1980 was 106,821,000.) The Japanese restraint, however, helps the American industry by limiting price competition and providing some stability to the market.

The costs to the rest of the U.S. economy, however, can be high. Most of the estimates are in the area of $100,000 per job saved.[1] The high cost derives from the fact that fewer imports raise the price of all automobiles sold. Thus, even a small increase in price is multiplied manyfold and spread over the few jobs which are saved.

An emerging problem is foreign supplies (or sourcing) of original equipment for American cars. The United Auto Workers Union has been advocating limits on the amount of foreign parts which can be used in cars sold in America in high volume. Such a provision would probably violate the General Agreement on Tariffs and Trade (GATT). Jobs would be saved but the cost to the U.S. economy per job saved could also be high.

3. *Steel.*—The U.S. steel industry, the largest and most efficient in the world two decades ago, has been virtually stagnant ever since, while the industry in Japan and some less developed countries has expanded markedly. To limit foreign competition and preserve jobs and capacity at home the United States imposed a trigger-price mechanism in 1978; earlier, in the years 1969–74, foreign suppliers agreed to several Voluntary Restraint Agreements.

The decline in the international position of the U.S. industry, according to a recent study of Robert Crandall of the Brookings Institution,[2] comes from normal economic forces, particularly declining shipping costs making importing cheaper, advanced technology installed abroad, and declining real prices for iron ore. Sharp increases in U.S. steel wages in the 1970's also contributed to the decline of the American industry; in the United States, workers' compensation rose to 70 percent above the manufacturing average, while in Europe comparable figures were only 12 to 25 percent above the average.

Crandall finds that a new, modern steel plant in the United States would produce more costly steel than existing plants in Japan and some less developed countries and even in the United States.

Crandall concludes that steel import protection is costly, that it cannot be justified on national security grounds, and that even without protection the industry will not collapse but can exist after some retrenchment. A major cost of protecting the domestic steel industry is that it puts a burden on the steel-using industries, for example, automobiles.

The policy question is whether the costs of protection are worth the benefits of maintaining a large steel industry in competition with efficient foreign producers. If the cost is judged to be too high, the question then becomes one of how the government helps the steel workers, firms and affected communities adjust to a smaller, more competitive industry.

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[1] See, for example, memorandum of Council of Economic Advisers in hearing before the Subcommittee on Economic Stabilization of the Committee on Banking, Housing and Urban Affairs, U.S. Senate, Apr. 3, 1981, pp. 75–83.

[2] Crandall, Robert W., "The U.S. Steel Industry in Recurrent Crisis: Policy Options in a Competitive World," Washington, The Brookings Institution, 1981.

4. *Textiles and Apparel.*—Imports of textiles and apparel have been subject to government control since 1961. The present international framework, the Multi-Fiber Arrangement (MFA), established under the General Agreement on Tariffs and Trade (GATT), became effective January 1, 1974, was renewed again in 1977 and 1981.

The MFA seeks to provide for an orderly expansion of world textile trade while, at the same time, avoiding disruption in individual markets. Under the provisions of the MFA, a country may restrain imports of textile and apparel products from particular countries through the negotiation of bilateral agreements with exporting countries or, where no agreement can be reached, through unilateral action. In accordance with the provisions of the MFA, the United States has concluded 23 bilateral agreements establishing restraint levels on specific products, and 10 additional bilaterals which rely on consultation to establish appropriate restraint levels.

Proponents argue that the Agreement has provided a reasonable degree of stability in international trade in textiles; that its absence would create chaos in that trade; that it has provided increased access to industrial markets for developing countries while limiting the possible disruptive effects on the industry in importing countries such as the United States. The MFA provides for a minimum of 6 percent annual growth in the trade quotas. (By comparison, the total U.S. market grows only by one to two percent per year.) There are, however, important exceptions to the 6 percent rule. Thus, the actual growth in trade in textiles and apparel can be both greater or less than 6 percent, depending on the specific item and market conditions. In general, the MFA seems to have opened markets in an "orderly" way, perhaps more than would have been the case had national import restrictions been imposed, but less than would have taken place with only the current high tariffs restricting the trade.

However, the renewed MFA allows for negotiated reductions in levels of trade and in the 6-percent minimum growth rate. The European Community, whose textile industry is depressed, is very likely to take advantage of this provision. The United States, however, has stated that it will not reduce current levels of imports though it will seek to limit future increases to less than 6 percent per year. The major suppliers—Hong Kong, Korea and Taiwan—are likely to be the target of any rollback in export quotas. The scheduled bilateral negotiations of this year are thus likely to test the commitment of the United States and Europe to liberal trade policies.

5. *Japan.*—Japan is now a formidable economic competitor, trading partner and market. It has the second largest economy in the non-Communist world. Its per capita GNP is growing rapidly, approaching that of the United States. It is not surprising that economic friction exists between the two most productive economies of the world and that economic questions dominate the dialogue between the two nations.

Particularly troublesome has been the large and persistent imbalance in trade between Japan and the United States. This is likely to be exacerbated in 1982 and 1983 if, as expected, the U.S. deficit in trade with Japan becomes significantly higher than the $10 billion deficit in 1980 and the $15 billion deficit estimated for 1981.

It seems likely that the expected increase in the U.S. deficit in trade with Japan will trigger renewed protectionist pressures. This would come at a time when Japan is opening its markets to U.S. goods, albeit late and at a measured pace. Its tariffs on manufacturers are not significantly higher than those of the United States. It does favor high technology industries through such measures as special tax concessions, government procurement, and easy access to credit. Other restrictions to imports and support for exports persist, but they tend to be buried in bureaucratic procedures, tax laws, Japan's distribution system, and Japan's culture. In agriculture, moreover, for domestic political and social reasons, protection is still high. Further Japanese liberalization here would seem to be called for by the rules of the GATT as well as the needs of the world trading community.

Japan can legitimately be asked to reduce its existing protection of agriculture and to open its other markets as wide as those in Western industrial countries. But pressing Japan to eliminate its bilateral trade surplus with the United States would, if effective, move our trading relationship to an inefficient system approaching barter. A good case, however, can be made for urging the Japanese to achieve an overall balance in their international payments on current account (i.e., largely trade in both goods and services). In that case, increased Japanese imports from third countries would provide finance and potential markets for U.S. exports there.

We can also suggest, as we have been doing, that Japan bear a larger share of the common defense and foreign aid burdens. A sound case can be made for both measures on their merits and both would also help to balance the American and Japanese trade position. However, given a budgetary deficit roughly twice as large (in terms of GNP) as that of the United States, major increases in Japanese spending for defense, now at 0.9 percent of its GNP, or aid are unlikely.

Japan's overall balance of payments on goods and services is volatile. The huge oil import bill threw it into deficit in 1980. In 1981 Japan is likely to be in surplus with all countries. As a rich country, it might well be expected to run a surplus, if such a surplus reflected long-term, stable investment in and aid to foreign countries. Toward this end, Japan might well look at the constraints limiting foreign borrowing on its capital markets.

The most effective way to reduce, if not eliminate, its growing trade surplus would be for Japan to take expansionary fiscal and monetary measures. This, however, is unlikely as Japan is concerned about the huge deficit in the government budget.

An easing of European restrictions against Japanese goods could contribute to improved economic welfare generally and relieve pressure on the more open U.S. market. This also is unlikely in the current economic situation.

6. *East-West Trade.*—Congress is likely to face a variety of questions about U.S. trade with Communist countries in the coming year. The most difficult one is whether, or how, trade can be used to achieve U.S. political and strategic objectives.

The grain embargo against the Soviet Union had mixed results. It imposed some costs on the Soviets but these were quite limited and, of course, did not induce the Soviets to withdraw from Afghanistan. The major reason for the lack of impact was the lack of cooperation of

some of the major grain suppliers, particularly Argentina. As a result much of the U.S. embargo was offset. Indeed one estimate is that Soviet grain supplies were cut by only one percent from pre-embargo levels.[3] However, costs were imposed on the Soviets. They had a shortfall in their expected supplies of feed and meat, and had to pay about one billion dollars more to replace the cheaper U.S. grain.

Similar problems arise on exports of manufactured goods. Unless the United States gets the cooperation of other potential suppliers, largely Western Europe and Japan, trade restrictions do not deny goods to the Soviet bloc but merely shift the purchases away from the United States.

For those few goods in which the United States has a monopoly, so that they could be denied the Soviets by U.S. action alone, one must attempt to measure the cost to the Soviets of going without the goods or using substitutes. The same question must be posed where the non-Communist nations act together to deny goods to the Soviets.

History (and Sputnik) has taught us to be skeptical of claims that denying a superpower (with a GNP of over $1,100 billion) a very limited amount of imported goods, even goods of high technology, can have a significant economic or military impact. Noting that real resources must be given up by the Soviets to pay for the imports—they do not come free—the net benefit to the Soviets of imports of high technology goods cannot be worth much more than two to three times the value of the imports.

The one case where U.S. export controls might be effective is for high technology goods of use to the military. This is not because the goods have immediate military applications, but because Soviet technological knowledge and skills are already high in the military area so that they can readily absorb, and learn from, foreign technology. Since U.S. exports of high technology goods to the Soviet Union are very limited—$183 million in 1979 ($270 million to Eastern Europe as a whole), about one-tenth of Soviet imports of advanced machinery and equipment from West Germany, France and Japan combined—the United States by itself has little leverage.[4]

Perhaps more effective than export controls would be limitations on the amount of Western credits available to the U.S.S.R. and Eastern Europe. But this too depends on cooperation by the European and Japanese governments since the bulk of the credit comes from non-U.S. sources.

B. Investment

U.S. policy has been consistently more liberal on foreign investment than on foreign trade. With some exceptions—on foreign ownership of U.S. defense industries, coastal and fresh water shipping, domestic air transport, hydro-electric power and exploitation of federal lands—stated policy has been that government neither encourage nor discourage inward or outward investment. Over the last 30 years there were very large outflows of U.S. capital, returns on which are now the most dynamic element in the U.S. balance of payments, earning an estimated $80 billion (gross) in 1981. Major exceptions to a neutral foreign investment policy are measures to encourage U.S. private

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[3] *Review*, Federal Reserve Bank of St. Louis, August/September 1980, p. 7, vol. 62, No. 8.

[4] The data and argument of this pargaraph are based on a RAND study (R–2649–ARPA) "Selling the Russians the Rope? Soviet Technology Policy and U.S. Export Controls" by Thane Gustafson, April 1981.

investment in developing countries and preferential treatment to new incoming investment by state and local governments.

In the late 1960's and early 1970's supporters of the Burke-Hartke bill and others argued that U.S. investment abroad costs the United States jobs, redistributes U.S. income from labor to capital, weakens the U.S. balance of payments and has some deleterious effects on our political relations, particularly with developing nations. These objections have receded in the 1980's.

Similarly, the outburst of concern in the 1970's especially in the developing countries and the UN, about the multinational corporation—about which volumes were written—has quietly subsided. The economic benefits of the corporations have it appears, proven persuasive and most countries learned that they could manage the multinationals one way or another, while benefiting economically from the infusion of capital, marketing ties and technological know-how.

Recently, with the increase in investment in the United States by foreign countries up by 50 percent from 1978 to 1980, there has been congressional concern about foreign control of U.S. corporations. Fear of foreign domination of the U.S. economy overlooks a number of practical realities: foreign companies are subject to U.S. laws, U.S. antitrust policy, U.S. taxes. They must bargain with American labor. The stock of U.S. direct investment abroad is three times as large as foreign investment in the United States—$213 billion compared with $65 billion at the end of 1980.[5] Finally, foreign investment in the United States adds to the real capital America and its workers have at their disposal.

The freedom for capital to move played a major role in easing the crisis imposed by the abrupt, huge jump in the price of oil in 1973–74 and 1979–80. If external financing had not been available, countries would have had to cut back on their imports of oil and other goods; the result would have been stagnation if not negative growth and increased unemployment. Freedom to invest abroad also kept oil flowing by encouraging oil-exporters to maintain oil sales even if they could not use their earnings immediately for internal development. They had a variety of avenues for profitably investing their idle funds.

The basic argument for not restricting capital movements is that the flows normally benefit both the exporting and the importing countries. The capital exporter gains higher returns than it would from investing at home; the capital importer sees fresh investment at home, and, consequently, enhanced economic growth.

The main drawback to U.S. foreign investment is that, unlike domestic investment, it may be subject to expropriation or to exploitive rules and regulations of a foreign country. Expropriation has not been a major problem in recent years but manipulation of foreign direct investment by host governments is.

Current foreign investment problems are of two types: first, special incentives to attract investment; second, special restraints on existing foreign investment requiring the investors to do such things as buy local products or export a given percentage of its output.

Currently, U.S. policy on foreign investment is being reconsidered largely because Canada has placed restrictions designed to limit for-

[5] Source: Survey of Current Business, U.S. Department of Commerce, August 1981. From this issue and the August 1979 issue, we calculate that the stock of direct foreign investment in the United States at the end of 1980 was less than 3 percent of total U.S. nonresidential capital.

eign—primarily U.S.—investment in Canada's oil and gas resources. Canada has worried about the large role played by U.S. capital in its economy for at least 60 years but, until now, has done little to change what has been a mutually profitable economic development. U.S. retaliation could raise economic and political problems worldwide. The OECD Code on the Liberalization of Capital Movements (adopted, June 1976) covers a limited number of subjects, including the free entry of investment but Canada is not a signatory to the code. A broader international understanding or an enlarged international code (similar to the GATT) on foreign investment may well be the way to handle such problems in today's world.

C. International Monetary Systems

The function of the international monetary system is to facilitate world trade and investment. The system has been a great success. World trade has risen much more rapidly than world production; international investment has risen even faster than trade. Until the 1970's, economic growth has been unprecedented. The fruits of success were shared widely, by developing as well as industrialized countries. The oil shocks of 1973–74 and 1979–80, which slowed economic growth in the 1970's, would have placed an even heavier burden on the world economy had the international financial system—private and governmental—not been resiliant.

In the 1960's making plans for a comprehensive reform of the world monetary system was a growth industry. The financial strains of the decade led to the collapse of the Bretton Woods system of fixed (but adjustable) exchange rates in 1971 when the United States suspended convertibility of the dollar into gold.

The post-war reform of the international monetary system has been achieved through responses to events, rather than as part of a grand design. While more remains to be done, it is now likely that there will be no new blueprint such as appeared at Bretton Woods in 1944. Rather the system will continue to evolve to meet new challenges. Indeed, in sharp contrast to the years from the early 1950's to the early 1970's there is now an absence of plans for a major overhaul of our current system. It has served well in the past; it is serving reasonably well now. Flexible exchange rates which have existed since 1973 have permitted us to weather the two oil shocks and the large differences in inflation among the industrial countries in the 1970's.

The system, of course, has problems. Exchange rate movements have been large and frequent, creating problems for many industries by subjecting them to large swings in orders, profits and costs. The development of multiple reserve currencies—the dollar, the DM and the yen—is a potential source of instability in the international monetary system; funds can shift quickly from one currency to another, making for volatile exchange rates. A separate problem is the debt burden of the oil-importing developing countries.

To reduce the volatility of exchange rates the world could abandon national currencies as international money and shift to the special drawing right (SDR) of the International Monetary Fund. A move to such an internationally managed money is unlikely soon, however: more experience with the SDR is necessary before any such radical

shift would be politically acceptable. The alternative is to live with a multi-currency system and to increase its stability by domestic policies conducive to price stability and steady economic growth in the major countries. Few would want to go back to fixed exchange rates especially while inflation rates are high and differ sharply from country to country.

Another suggestion now being studied in the United States is to return to the gold standard. Its proponents argue that it would limit the creation of domestic money, thereby freeing the supply of money from political control and reducing inflationary pressures. Most economists, however, are skeptical of the benefits of the gold standard. Fixing an appropriate price for gold, which has varied between $217 and $850 an ounce since 1979, is crucial and would be difficult. Too high a price would see U.S. gold reserves and money supply soar, with inflationary consequences; too low a price would have the opposite results. There would also be the constant threat that the supply of gold would not increase fast enough to provide the money supply for economic expansion, as happened in the late 19th century when most of the world was on a gold standard; the result was deflation and depression. Moreover, three-quarters of the new gold supply comes from sources widely considered unreliable, South Africa and the Soviet Union, and disruptions in any part of the world could prompt nervous investors to switch to gold, forcing a monetary and probably economic contraction in the United States. If other countries also were to adopt the gold standard, which now seems unlikely, we would have returned to a world of fixed exchange rates, as in the Bretton Woods agreement, since every currency would have a fixed price for gold. Such a system can work only if countries subjected their domestic policies to strict discipline to keep the exchange rate (or, its equivalent, the price of gold) fixed. Under pressure, such as the oil shocks of the 1970's, the results could be unacceptably high unemployment or, even, high rates of inflation worldwide.

D. Energy

In an otherwise sobering economic environment, the sharp improvement in the energy situation and outlook stands out as a welcome tribute to sound economic policy. The United States and most other countries have allowed the higher cost of oil to be passed on to consumers. The result has been that oil consumption in the major industrial countries fell by 8 percent in 1980,[6] and a similar reduction is expected in 1981. The energy required per dollar of gross national product is now 13 percent below the 1973 level.[7] While energy consumption in the postwar period rose roughly in line with the growth of GNP, since 1973 energy demand has grown at half the rate of growth of GNP. In short, there has been a marked increase in conservation or efficiency in the use of energy. This trend is continuing as high prices induce a change in the stock of capital and private automobiles to more fuel efficient machines and production processes.

At the same time, production of oil from non-OPEC sources has increased by two million barrels a day over the past two years and

[6] International Energy Statistical Review, National Foreign Assessment Center, Sept. 29, 1981.

[7] Monthly Energy Review, Department of Energy, August 1981.

increases of 500,000 barrels a day are expected for each of the next three years. The net effect of these factors plus the current economic slowdown has been a drop in the demand for OPEC oil to some 24 million barrels a day in the first half of 1981 compared to 31 million barrels in 1973. With a capacity of some 35 million barrels a day, OPEC is only producing at 70 percent of its current potential.[8] The result is an oil glut and a decline, real and nominal, in world prices.

Events of the last few years have proved again that "all long-range economic forecasts are wrong." Forecasts of a shortage of oil and persistent, large increases in price, induced governments and, more important, the private sector to take measures to adjust to the expected situation.

Nevertheless, the current situation does not call for Pollyanna to displace Cassandra on center stage. Much of the world's oil supply comes from the Middle East. But outside of Saudi Arabia, no Middle East country is important by itself, with none now producing more than 1.7 million barrels per day. Saudi Arabia, however, supplies 9.5 million barrels per day, almost 20 percent of oil consumption of all non-Communist countries. If its production were significantly reduced by war, revolution, politics or natural catastrophe, the economic impact would be very serious. Or, if the Middle East countries should act together to reduce exports significantly—unlikely in the current and prospective economic scene—similar results might occur.

The availability of an adequate oil stockpile in the United States—the Strategic Petroleum Reserve—would do much to meet these threats. Cooperation with our allies, through the International Energy Agency, to build stocks and to share supplies in case of a shortfall is also another insurance policy which it is prudent to maintain. However, oil sharing has never been put to the test, and the will of countries to implement it is in doubt.

The third line of insurance—government support for the development of synfuels or other non-conventional sources of energy—is more debateable. Government support for basic research appears to have a high rate of social payoff and seems clearly justified by experience. However, economic arguments for government subsidies (direct and indirect) for "demonstration" plants are less certain; high prices for energy may be sufficient to induce sound investment to produce synfuels. Nevertheless, the high risks, the huge amounts of capital required for synfuels and the uncertain outlook for energy prices inhibit investment and might justify some government support, support which could prove beneficial to society in the long term.

E. North-South Relations and Foreign Aid

1. *General.*—The major remaining ecenomic and political problems—and a major sign of hope—are in the developing countries. Two features stand out:

(a) Widespread poverty is common and persistent for half the people of the globe. As shown in the appendix table, 2.3 billion people live in countries with average incomes below $400 per person, according to World Bank estimates for 1979.

(b) On the other hand, a number of developing countries are making extraordinary economic progress. As can also be seen from

[8] International Energy Statistical Review, op. cit.

the appendix table, the average rate of growth of GDP in the middle income countries in the 1970's was 5.5 percent per year, compared to 3.2 percent for the industrial market economies. A sustained growth of 5.5 percent is remarkable, exceeding by far the growth of the United States and Western Europe in the 1970's and even exceeding that in the early stages of their economic history.

Countries as different as South Korea, Paraguay and Malaysia have made great progress despite two oil shocks of the 1970's. These countries have let the higher cost of energy and food be reflected in domestic prices rather than government subsidies. They devalued their currencies to keep their industries competitive. They lowered tariffs and dismantled import quotas for the same reason. The NICs—newly industrializing countries, notably Brazil, Korea, Taiwan, Hong Kong and Singapore—have been successful in good part because they have used market forces to stimulate their economies.

The postwar record of economic successes and failures demonstrates that domestic economic policies are the key. If these are favorable to economic growth, foreign aid can be a helpful and perhaps necessary supplement. If domestic policies are not conducive to growth, much of the foreign aid can be wasted.

While sensible domestic economic policies are necessary for economic growth, they are not sufficient by themselves. Availability of natural resources can help but, as the examples of Taiwan, Switzerland and Israel demonstrate, human resources, skills and entrepreneurial talents can substitute for resources. A market economy can also help, but there are countries, for example, Uruguay and Argentina, with market economies but slow growth, and there are non-market economies, for example, Romania, with rapid growth.

While sound domestic economic policies are clearly essential for economic growth, the low-income, or poorest, countries have special problems. They can take little advantage of export markets (their exports of primary products are at the mercy of world markets; potential exports of simple manufactured goods, for example, textiles and shoes, are frequently limited by restrictions imposed by advanced countries). The poorest countries cannot borrow on commercial terms. Their GNP per capita averages $230 per year, leaving little room for domestic savings and investment.

2. *Global Negotiations and the Brandt Report.*—The United States and the other affluent nations have had sharp differences with the organized developing countries (in the Group of 77) over economic policy for more than a decade. The United States has been advocating measures designed to increase the productivity of the world economy, to increase the size of the pie. The LDC's, on the other hand, have been more interested in getting a larger share of the pie now.

Widespread disagreement between the United States and many LDC's persists on basic issues, notably:

The amount of economic aid;

Whether the aid is to be made available automatically or at the discretion of the aid-giving government or international agency;

The degree of governmental intervention in international trade, particularly to bolster prices of primary commodities;

The decision-making process in international economic affairs and the extent to which it should be based on the concept of na-

tional sovereignty (one country, one vote as in the UN General Assembly) versus weighted voting based on economic factors (as in the IMF or World Bank), or purely voluntary cooperation or unilateral actions (as in bilateral aid).

A prestigious international commission under the chairmanship of Willy Brandt issued a report in 1980 entitled "North-South: A Programme for Survival." In large measure the report accepted, uncritically, the proposals and arguments of the New International Economic Order, focusing on what the North can do for the South. It proposes that the North should allow major decisions over trade, aid and investment be made by majority vote, or effectively by the South. Currently, most decisions are made unilaterally, by an aid-donor, for example, or in institutions, such as the IMF and IBRD, where there is weighted voting. While foreign aid and trade measures are important, the report made scant mention of the central role of domestic LDC policies in achieving economic growth. The report would not "suggest that changes in domestic policy must be a prior condition for reforms in the global system." The report played down the great progress a number of LDC's have made, the reasons for this progress, and the fact that the international economy and its institutions (particularly the IMF and the World Bank) have been evolving in ways favorable to the LDC's. Not surprisingly, the Brandt Report has drawn considerable criticism for making no serious attempt to work out an approach that would meet the needs of the LDC's in ways which the developed countries could adopt.

Economic relations with the developing countries are clearly beneficial to the United States and other industrial countries—one-third of the exports of industrial countries are purchased by the developing countries, the latter are now a larger market for U.S. goods than Japan and the European Community combined. Yet the Brandt report overstates the case when it argues that massive transfers of resources from the North to the South are essential to economic growth of the North; it assumes that the North needs expanding foreign markets to achieve and maintain full employment and that such expansion cannot occur without a massive transfer of resources. Finally, the report's advocacy of redistribution of world income is weakened by bad distribution of income within most LDC's.

The South is a collection of numerous countries with widely differing economic problems and prospects. Their demands differ and often conflict. The poorest, notably the smaller African countries, want a moratorium on debt. Those with good credit ratings, for example, Brazil, are concerned that a moratorium would inhibit new credits for them. The NIC's want access to markets. The poorest, like Bangladesh, prefer concessional aid. The thing they have generally agreed on is to put all the requests on the table and issue a united call for "global negotiations." The latter term has come to be understood as an invitation to negotiate a wide range of economic and political concessions by the North, preferably in a UN General Assembly framework of one country, one vote.

The plight of many LDC's, especially the poorest in Africa and Asia, is clearly serious. Yet, a global negotiation or dialogue along the lines recommended in the Brandt Report, or by the New International Economic Order, with one country having one vote could be counter-

productive, making construction solutions difficult to achieve. Rhetorical debates about "massive transfers of resources" or "power" at the expense of the industrial countries are likely to exacerbate problems rather than ease them. Such a dialogue would, if experience is a guide, divert attention from issues of trade, investment, aid and, more generally, the domestic economic policies of both the LDC's and the industrial countries, areas of realistic promise for the goals of all participants. Acceptance of the demands of some LDC's that IMF resources be loaned with fewer conditions on the domestic economic policies of the recipients would eliminate one of the more potent forces for sound economic policies. However, discussions dealing with development problems which can be resolved cooperatively without degrading those institutions which have contributed to world economic growth in the past 37 years could be fruitful. Such a dialogue would require changes in attitudes by leaders of the South and by some of the North as well.

At the Cancun summit meeting of October 22–23, 1981, the 22 participating governments agreed to global negotiations. President Reagan agreed subject to four conditions: the global talks be aimed at specific development problems and proposals; the existing financial institutions, particularly the World Bank and International Monetary Fund, not be altered and that their decisions not be made subject to review; talks focus on economic growth not "massive transfer" of resources; and the talks be held in a spirit which would avoid polarization of rich and poor countries.

3. *Rationale for Aid.*—In looking at North-South economic relations, the basic question is why the United States should be concerned about poverty and stagnation in developing countries.

One school of thought, especially in a period when domestic programs to help the American poor are being cut back, holds that special assistance for the less developed countries (LDC's) is not justified:

Foreign aid does not win friends or influence people.

Aid given on concessional terms is more likely to be wasted.

There is no clear link between foreign aid and economic growth, and between economic growth and the development of political systems congenial to U.S. interests. Rapid growth in Iran probably contributed to its current instability.

Aid, usually given by governments to governments, may strengthen the less productive public sector at the expense of the private economy.

Much of the developing world is anti-Western and anti-capitalist; why sacrifice to strengthen such societies?

Foreign aid at times is siphoned off by corrupt officials.

Food aid can depress local food production.

Humanitarian aid (such as disaster relief) ought to be the province of private citizens not governments.

Those in favor of helping the LDC's deny much of the above and advance numerous arguments:

There are compelling moral or humanitarian reasons to help—they are poor, we are rich.

A world in which the hopes of a large number of people are constantly frustrated by economic conditions is likely to be a world of political instability, dangerous to all.

Even if the United States and the other affluent countries could have only a marginal impact on poverty, failure to act, failure to show compassion, would run the risk of alienating much of the world's population.

The United States and the rest of the developed world depend increasingly on imported materials. In a world of political instability, anti-Westernism, anti-capitalism, and internal strife abroad, the needed investment for these supplies would not be forthcoming and we would find ourselves with more frequent and more severe shortages of basic raw materials.

Foreign aid gives the donor, whether the United States or the World Bank, an opportunity to influence the economic policies of the recipient governments.

Without aid, poverty in most developing countries would persist, if not deepen, providing fertile grounds for political systems antithetical to U.S. values and interests.

Foreign aid is strongly supported by our European allies; if the United States were to eliminate or even reduce markedly its aid effort, the reaction in Europe would be negative.

Foreign aid is a basic instrument of U.S. foreign policy. It is a means of supporting friends and encouraging developments favorable to U.S. interests.

Like so many issues in public policy, neither proponents nor opponents of foreign aid have proved, or can prove, their case. Nevertheless, after vigorous internal debate and study, the Reagan Administration has concluded, like the Republican and Democratic administrations since the end of World War II, that selective foreign aid is in the national interest. A number of issues remain. Most important is the amount of foreign aid.

4. *Amount of Aid.*—A variety of econometric studies can churn out numbers of how much foreign capital the LDC's can absorb economically and how much it would cost to raise their standards of living to given levels. For example, UNCTAD (the UN Commission on Trade and Development) concludes that to support a 3.5 percent growth in per capita gross domestic product, the least developed countries would require $11 billion per year in external capital during the 1980's and the World Bank puts the borrowing requirements of all developing countries at between $84 and $95 billion per year in 1985.[9]

Clearly, such estimates vary widely and depend on arbitrary assumptions. Political uncertainties keep private investors from exploiting many profitable opportunities, as does the very long-run pay-out of some investments. Some investments, for example, in health, education and economic infrastructure (roads, irrigation facilities, etc.) have a high social return but are not attractive to private investors. And, of course, funds could well be used to achieve political, national security or humanitarian goals. While private foreign investment now meets the bulk of the LDC demands for external capital, it cannot meet the full demand which is economically justified.

The huge "needs" of the LDC's for funds to reduce poverty and support economic growth, and the difficulties in quantifying the

[9] World Development Report, 1981, p. 13.

amounts "needed," shifted the discussion to the amount of aid which the donor countries can "afford" to give. Under U.S. leadership, since 1961 the DAC (Development Assistance Committee of the OECD) has published data comparing the amount of aid as a percentage of GNP given by the major donor countries and used this device to pressure countries to increase their foreign aid. The U.S. objective originally was to relieve the United States (and, more specifically, its balance of payments) of bearing a disproportionate share of the aid burden.

Today the shoe is on the other foot. While the United States is the largest single aid donor by far, we now lag well behind the other major OCED countries in the amount of economic aid [10] given to poor countries as a percentage of GNP, the accepted measure of effort. The United States ranks 13th out of 17 DAC countries. Only Austria, Italy, Finland and Switzerland give less as a percentage of GNP. In the last two years, the United States had given something over 0.2 percent of its GNP as aid, compared to an average of 0.4 percent for all other donors. France's share is three times that of the United States; Germany's, is twice.

Popular opinion to the contrary, U.S. foreign aid programs are, in these terms, small, and, in contrast to other U.S. expenditures, foreign aid has been declining steadily in real terms for over a decade. U.S. aid (in constant prices) in the 1970's was one-third below that of the 1960's. This has not been an area in which U S. budget expenditures are out of control.

5. *Bilateral vs. Multilateral Aid.*—Is U.S. aid more effective if given multilaterally—jointly with other donors—with the U.S. role submerged and U.S. control less visible and dominant?

This also is an old question which has been debated for over 30 years. The functions of the two kinds of aid differ. Bilateral aid usually has political, more short-run-objectives than multilateral aid, which is generally aimed at long-run economic and social development. Moreover, multilateral aid attempts to mobilize world, rather than only U.S. resources for this task.

Some early OMB documents of the current Administration have asserted that bilateral aid is more effective in achieving U.S. objectives than mutilateral aid. This is debatable.

On the one hand:

> The multilateral banks have loaned money to countries (notably Vietnam) and for purposes that we oppose. Congressional and U.S. control over the international agencies is limited.
>
> Multilateral aid can not be turned on and off in response to changes in conditions and U.S. policy as can bilateral aid. Bilateral aid can be targeted to immediate U.S. national interests (as aid to Egypt, Israel, Nicaragua or Salvador has been), while multilateral aid generally (but not always) aims at long-term economic development for a wide range of countries.

On the other hand:

> Because of the leading role that the U.S. plays in the multilateral banks, more often than not, the loans have been supportive of U.S. political and economic interests. For example, recently,

[10] Official development assistance which excludes military assistance and private help and investment.

at the request of the United States, the World Bank took the lead in an expanded lending program for the Caribbean. And, four of the 10 largest borrowers from the World Bank in 1980 (India, Indonesia, Turkey and the Philippines) are among the 10 largest recipients of U.S. bilateral aid. Indeed, a recent U.S. Treasury report says, "the MDB's, by and large, have been effective in furthering our global economic and financial objectives and thereby also serving U.S. political/strategic interests." [11]

The United States can influence total multilateral bank lending. Moreover, U.S. contributions multiply the total amount of world foreign aid as foreign countries more than match the U.S. contribution and as the banks borrow from private sources. More specifically, every dollar of equity the United States contributes to the World Bank generates almost $70 of lending to developing countries. (This results from the fact that only 7½ percent of capital subscriptions are paid in and the U.S. share of the capital is only 20 percent.)

6. *Multilateral Aid.*—The multilateral development banks (MDB)—the World Bank Group, the regional development banks: the Inter-American Development Bank, the Asian Development Bank and the African Development Bank—provide only 6 to 7 percent of the international capital going to developing countries. Yet, this understates the importance of the MDBs. First, the low-income countries depend heavily on these banks. Second, MDB funds act as a catalyst, attracting private capital. Finally, the international institutions provide more effective and more acceptable guidance on LDC domestic economic policies than do commercial banks or private investors. The ability of the World Bank to collaborate with private investors supplements the resources available to the LDC's, allows for stricter conditions on LDC domestic policies than private investors could demand, and, of great importance to bankers, reduces the risks of international lending.

These factors plus other considerations have recently changed the Reagan Administration attitude from neutral if not negative to being positive about the role of the World Bank and the other MDB's in meeting broad U.S. economic and foreign policy objectives. Nevertheless, the same Treasury report which drew such a conclusion goes on to recommend: "The U.S. should develop and initiate a plan to phase down, and eventually phase out, public financing (including callable guarantees) for the hard loan windows" and "should begin to reduce its participation, in real terms, in the soft loan windows, especially IDA, taking into account the impact on U.S. economic and political objectives." [12]

7. *IDA Lending.*—The second recommendation raises the issue of the soft loan (no interest, 50-year term) window of the World Bank group, the International Development Association or IDA. The United States has stretched its budgeted contribution to the 6th replenishment of the International Development Association (IDA) over four years instead of the three agreed upon internationally and adhered to by other countries. This delay plus official U.S. comments has fed rumors that the United States would not fulfill its full commitment for the

[11] Department of the Treasury, *Assessment of U.S. Participation in the Multilateral Development Banks in the 1980's*, September 21, 1981, p. 5.
[12] Ibid., p. 10.

IDA–VI replenishment and would not agree to a 7th IDA replenishment in 1984, or if it did, the amount would constitute a sharp cut in real terms. As a result, on Sept. 30, 1981, the other major donor nations that had met their IDA commitments voted not to meet their commitments for the second and third years of IDA–VI until the United States does.

IDA credits go only to the countries with GNP per capita of less than $350 per year. They usually cannot borrow commercially. Thus, delays in contributions and cuts in U.S. contributions, which are being matched by other donors, would be a severe blow to the largest source of international investment support for the poorest countries of the world. The Treasury report concludes that:

> In foreign policy terms, a very sharp reduction, or a refusal to participate at all, would be interpreted as an abdication of U.S. leadership. It would do serious damage to U.S. relations with most developing countries, and undercut our credibility and prestige with most of our important industrial allies. It would also seriously impede our economic and humanitarian objectives, since the soft loan windows would have to reduce sharply, or in some cases even cease operations.[12]

A related concern is that India and China (which became a World Bank member in 1980) are likely to come to the MDB's for financial assistance in the coming years. In May 1981, the Peoples Republic of China got a $200 million loan, half from the World Bank, half from IDA. India has been voted (the United States abstained) a $5.8 billion loan the I.M.F. With 1.6 billion people and low ($230) per capita incomes, their requests will probably be huge and will be for concessional aid rather than hard loans. Large, soft loans raise problems for the MDB's and the economic and political orientation of India and China raise special issues for the United States.

It is important to note that IDA loans follow the same criteria as World Bank loans. The only difference is the terms. Moreover, as countries advance economically, they "mature" from IDA to the World Bank, from soft loans to hard loans—S. Korea, the Philippines, Thailand, Ivory Coast and some 15 similar countries have done so. And, more successful developing countries, such as Israel, Ireland, Greece and Spain, "graduate" from the World Bank to the private sector. One question for policy is the pace of maturation and graduation in the future.

If U.S. contributions to international aid were reduced, U.S. prestige and influence might suffer; the latter, because voting rights in the MDB's are weighted in line with a country's contribution. One problem for U.S. policy is how to avoid or reduce such erosion.

8. *Other Means of Transferring Resources to Developing Countries.*—There are a variety of means other than foreign aid or private investment to transfer resources to the LDC's. Each has advantages and limitations.

(a) Trade preferences, under which exports of some LDC goods are free of all or most of the duties applied to similar exports from industrial countries, have been in effect since the mid-1970's. There were high

[12] Ibid., Section IV, pp. 14 and 15.

hopes that such measures would stimulate LDC exports and investment. However, the restricted nature of the U.S. and European schemes prevented the programs from having a significant effect.

(b) The creation of additional SDR's to be used as foreign aid (or as a "link" between development aid and the supply of international liquidity) has been recommended. However, the concept has less to commend it today than when it was first proposed a decade ago. Its proponents stress that additional SDR's could provide aid automatically to the poor countries, avoiding the problems of annual congressional or parliamentary authorizations and appropriations. Opponents argue that world liquidity is adequate, if not excessive, today, that large additions of SDR's would be both inflationary and undercut their potential usefulness as the basis for the world's monetary system. Moreover, the recent sharp increase of the interest charged on SDR's when they are used, makes them much less attractive than when the interest charged was nominal.

(c) Arguing the questionable proposition that the prices of manufactured goods imported by LDC's rise faster than the prices of the primary products they export, the LDC's propose commodity agreements to meet this problem and to stabilize volatile prices movements for primary products. The United States participates in a few agreements—natural rubber, sugar, coffee and tin. Commodity agreements tend to break down. If the support prices are set too high, demand is restricted and substitutes replace the protected product leaving the authorities with a growing financial burden and huge stocks of an unwanted commodity. If prices are set too low, the agreement breaks down as sellers take advantage of demand to charge higher prices.

To meet the problem of volatile export earnings of the LDC's and avoid the drawbacks of commodity agreements, IMF has a compensatory financing program. It lends to countries when their export earnings on primary products fall below trend.

(d) Clearly, expanding economies and open markets in the industrial countries, plus lower interest rates could make major contributions to economic growth world-wide, especially in the middle income developing countries. Indeed, since 1960 the volume of exports of the developing countries, excluding OPEC, grew by 6 to 7 percent per year. Particularly strong was the growth in LDC exports of manufactured goods to the industrial countries. Here, the role of the U.S. market, which takes half of the manufactured goods exported by non-OPEC developing countries, is particularly important. The current economic slowdown, however, has stopped the growth in LDC exports. And, high interest rates raise the cost of borrowing and of servicing past indebtedness. The rate of interest paid on the bulk of LDC debt today is flexible and reflects current rates. Each percentage point increase in interest rates costs the LDC's over one billion dollars per year,[14] a huge additional burden to carry. Clearly, non-inflationary economic growth in the United States would do much to help economic development abroad.

[14] See William Cline, "Recycling and the Debt Problem of Developing Countries."

WORLD ECONOMIC INDICATORS

Region and selected countries	Population (millions) mid-1979	GNP per capita		Growth of GDP annual (percent)		Exports, annual real growth (percent)	
		Dollars, 1979	Annual growth (percent) 1960–79	1960–70	1970–79	1960–70	1970–79
A. Low-income countries	2,260.2	230	1.6	4.5	4.7	5.0	−1.0
India	659.2	190	1.4	3.4	3.4	3.0	4.6
China	964.5	260	----------	5.2	5.8	----------	----------
Other low-income	636.5	240	1.8	4.3	3.8	5.3	−1.1
B. Middle-income countries	985.0	1,420	3.8	6.1	5.5	5.4	4.3
Selected countries:							
Thailand	45.5	590	4.6	8.2	7.7	5.2	12.0
Paraguay	3.0	1,070	2.8	4.2	8.3	5.4	8.4
Malaysia	13.1	1,370	4.0	6.5	7.9	5.8	6.5
Korea, Republic of	37.8	1,480	7.1	8.6	10.3	34.1	25.7
Mexico	65.5	1,640	2.7	7.2	5.1	2.8	10.9
Brazil	116.5	1,780	4.8	5.4	8.7	5.1	7.0
Romania	22.1	1,900	9.2	8.6	10.6	9.4	4.7
Uruguay	2.9	2,100	.9	1.2	2.5	2.2	4.3
Portugal	9.8	2,180	5.5	6.2	4.5	9.6	−.3
Argentina	27.3	2,230	2.4	4.2	2.5	3.4	10.7
Yugoslavia	22.1	2,430	5.4	5.8	5.9	7.7	4.7
Hong Kong	5.0	3,760	7.0	10.0	9.4	12.7	8.3
Singapore	2.4	3,830	7.4	8.8	8.4	4.2	11.0
Greece	9.3	3,960	5.9	6.9	4.9	10.8	12.3
Israel	3.8	4,150	4.0	8.1	4.6	11.0	9.8
Spain	37.0	4,380	4.7	7.1	4.4	11.5	10.8
C. Industrial Market economies	671.2	9,440	4.0	5.1	3.2	8.4	5.9
Selected countries:							
United Kingdom	55.9	6,320	2.2	2.9	2.1	4.8	8.2
Japan	115.7	8,810	9.4	10.5	5.2	17.2	9.1
France	53.4	9,950	4.0	5.7	3.7	8.2	7.1
United States	223.6	10,630	2.4	4.3	3.1	6.0	6.9
Germany, Federal Republic of	61.2	11,730	3.3	4.4	2.6	10.1	6.0
D. Capital—Surplus oil exporters [1]	25.4	5,470	5.0	----------	6.5	8.2	−2.0
E. Nonmarket industrial economies	351.2	4,230	4.3	4.8	5.2	9.0	7.5
U.S.S.R.	264.1	4,110	4.1	5.2	5.1	9.7	7.3
F. Total	4,293.0	------	2.7	5.1	3.9	6.5	4.6

[1] Iraq, Saudi Arabia Libya, Kuwait.

Source: The World Bank. "World Development Report 1981," Washington D.C.

A COMPARISON OF ECONOMIC POLICIES AND DOCTRINES IN THE MAJOR INDUSTRIAL COUNTRIES

By James K. Galbraith*

In the period leading up to the electoral reversals of 1980 in the United States and 1981 in France, it was possible to state that the leading countries of the OECD shared a common economic policy perspective: priority to the fight against inflation, primary emphasis on the monetary instrument in that fight. There were, of course, nuances: a strongly deflationary and monetarist policy in Britain, "managed" recessions in France and the United States coupled with differing degrees of selective credit intervention, an attempt to steer a middle course between inflation and recession in the Federal Republic.[1] But on the whole a greater degree of consensus reigned then than at any time since before the first oil shock.

That common perspective has now abruptly disappeared.

In the United States, the inauguration of Ronald Reagan signalled a shift from the moderately conservative economic policy of the second half of the Carter Administration to an economic politics of the bona fide Right, New and otherwise. In its first six months, the Reagan Administration pushed through Congress an "Economic Recovery Program" whose principal theme is redistribution upward in a context of mixed macroeconomic signals. This program includes sharp cuts in social spending, cuts in personal taxes proportional to previous tax rates (and hence weighted toward upper income groups), increases in military expenditure, and a sharp reduction of the income tax on corporations, all supplemental by a stringent Federal Reserve program of tight money and high interest rates. In standard Keynesian terms, the timing of the tax and spending reductions was such that macroeconomic policy has moved sharply in the near-term toward contraction. From mid-1982 onward, however, there will be fiscal stimulus as the tax reductions and military build-up take hold, with the net effect to be determined by the eventual posture and the effectiveness, never before tested under such trying conditions, of monetary policy. After an early flirtation with the optimistic projections of the so-called "supply-side economists", even the Administration shifted toward a pessimistic outlook after its program cleared Congress, warning on the following day that the public should not expect immediate or even eventual miracles.

In France, another dramatic political reversal took policy in the opposite direction. The Socialist Party took power only three years after it had seemed definitively defeated in the parliamentary elections of 1978. The immediate result was an economic policy of short-term stimulus and longer-term structural reform, including nationalization of certain industries and the deliberate fostering of employment-

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[1] Japan as usual is a special case as will be discussed later on.

creating and import-substituting enterprise. This was as near as possible an exact opposite to the Reagan program. Spokesmen for the new French government began to speak of the need for a "planetary new deal", raising the possibility of an economic policy alliance of smaller industrial countries under French leadership and even the spectre, thought by some to have been extirpated, of a return of Keynesianism, this time on an internationalized basis.

In the United Kingdom, events were pushing the nation if not yet the government toward a rejection of the combination of monetarism and supply-side economics which the Administration in Washington had so recently embraced. While Mrs. Thatcher's sympathetic critics in conservative circles continued to prescribe reforms of the Bank of England's monetary control procedures, the citizens of Britain's inner city ghettoes carved out for such places as Toxteth and Brixton an international reputation and for themselves a role in economic policy-making. In Warrington and elsewhere, a more traditional breed of Englishman showed in by-elections the depth of dissatisfaction. One statistically overdrawn but indicative analysis reported on the BBC was that, if replicated nationwide, the Warrington results would leave the Conservative Party with but a single seat in the Commons. By midsummer the streets had quieted but the Tory Wets appeared to be gaining ground: a $1 billion jobs program was announced for the benefit of Britain's massively unemployed. Many observers began to feel that the long-awaited U-turn would not be too far off.

Germany, after the return of the Social Democratic/Free Democratic coalition in the elections of 1980, underwent a political transformation of a more subtle but equally disunifying kind. The proximate causes were not generally economic, despite considerable frustration in Germany with the government's inability to move against mounting unemployment. Instead, the evident decline in political support for the Chancellor and his government could better be traced to personal factors and to Social Democratic feuding over such issues as the arms race. Nevertheless, the effect was to contribute to the polarization over economic policy within the OECD. Germany found itself increasingly pressed by international interest rate levels on the one hand and by pressures inside the ruling coalition on the other to take a position squarely opposed to the radical monetarist policies of Mrs. Thatcher and President Reagan. Chancellor Schmidt straddled the issue, softpedalling interest rates at Ottawa while declaring, on June 8, 1981, that Germany would "never, under any circumstances", adopt a monetarist policy on the British model.

The other major OECD countries, Japan, Italy, and Canada, experienced fewer profound changes and were less inclined to be strongly committed for or against the new American policy when the Group of Seven convened at Ottawa in July. In addition, the leaders of Japan and Italy were both newly installed and little known figures, which may have increased their reluctance to make waves. Nevertheless, they, like the others, were feeling the pain of slow economic growth and the frustration of policy paralysis imposed in part by the high level of international interest rates. And so, if they did not contribute to the polarization, they did not act to reduce it either.

Abrupt changes in the economic policies of major governments often either induce or mirror changes going on at the philosophical

level. In Europe and the United States in 1981, these deeper changes included the climacteric of monetarism and the search, so far by no means settled, for something with which to replace it.

The gathering disillusion with monetarist prescriptions for the control of inflation has something to do with the experience of monetarism in Britain, something with the arrival of monetarists in power in the United States, something with the correction of widespread misperceptions of the way monetarist principles have been applied in those OECD countries which have a strong record against inflation, notably Germany, and something with inherent intellectual difficulties of the argument.

Mrs. Thatcher's government provided in its first two years the most dramatic experiment with monetarism to date. Hitherto, only small open economies with peculiar circumstances of war or revolution had come under the sway of the Chicago doctrines. In those cases, failure to restore prosperity and stable prices, however manifest, could not be attributed to monetarist economic policy alone—too many other factors were at work, and in any case the econometric microscopes were never turned on with full professional intensity by top scholars. Israel and Chile are too small and too remote.

Britain is different. It is the cradle of international free trade and of western free market ideology, as well as of Fabian socialism and of John Maynard Keynes. What better or more definitive site for a test of the ideas of that anti-Keynes, Professor Milton Friedman? What more gripping drama for a profession (and its journalistic hangers-on)? What better circumstances: a committed politician, a strong government, a country weary of economic decay and eager for change? So, when Mrs. Thatcher took office, friend and foe of her government alike predicted that the laboratory test of monetarism was at hand—even though Professor Milton Friedman himself only appeared in the first days and thereafter discreetly kept his distance.[2]

The results have not been clear-cut, but their impact on the international reputation of monetarism has been severe nevertheless. Thatcher's government may not have proved, in any acceptable scientific sense, anything about the suitability of monetarist doctrine as economic theory. But it has effectively laid to rest the range of arguments advanced by the practical men of monetarist economic policy planning concerning the feasibility of implementing such policies, and it has decisively refuted their optimistic predictions regarding the cost of trying.

Mrs. Thatcher's government is distinguished from its predecessor, not by the implementation of monetary targets, which have been established in the United Kingdom since 1974 and been made a public feature of economic policy since the IMF agreements of 1976, but by an "overriding priority" assigned to the control of inflation, in which monetary instruments are the main if not the only tools.

The shift to an "overriding priority" against inflation was in the service of a simple idea, namely that the more credible the government's anti-inflation policy could be made to seem, the less costly to society it would turn out to be. Thus, the single numerical target for

[2] In a memorandum submitted to the House of Commons on June 11, 1980, Friedman endorsed the monetary "strategy" of the Thatcher government, but attacked its "monetary tactics," calling them "egregious" and "simply wrong." House of Commons, Treasury and Civil Service Committee, Memoranda on Monetary Policy, London, HMSO, July 17, 1980, pp. 55–61.

money growth would be made the centerpiece of policy around which all other activity would revolve. The "credible threat" of unemployment if wage settlements pushed up prices faster than money would deter labor in collective bargaining. The "rational expectation" of lower future inflation would bring interest rates down. And "'supply-side" policies, including denationalization and deregulation, would further reduce the pain by raising productivity and creating new employment opportunities.

But this "overriding priority" attached to the fight against inflation, when coupled with other aspects of Mrs. Thatcher's ideology and of the British economic scene, proved singularly unhappy for the reputation of monetarism as a practical policy. In the first place, commitment to quantitative monetary targets presupposed the selection of a particular measure of money and the specification of its target rate of growth. In Britain, both tasks had essentially been performed before Mrs. Thatcher by the previous Labour government. The new government considered itself bound by the monetary targets of its predecessor, since to change the aggregate or increase its rate of growth in the interest of good policy or even of realism seemed to pose an unacceptable risk of perceived lack of discipline on inflation. So Mrs. Thatcher accepted a monetary aggregate, sterling M3, whose rate of growth was highly susceptible to changes in credit management techniques and international liquidity flows, at a stipulated rate of growth which probably could not be met without exchange controls and quantitative ceilings on bank liabilities, both of which the new government was committed to end. Thus the policy courted a severe (and unnecessary) credibility problem right from the start, as measured growth of sterling M3 surged ahead despite a demand management policy that was sharply deflationary.

The growth of sterling M3 was spurred by several distinct events and policies. The removal in June 1980, of the "corset," a program of quantitative controls over bank desposits, caused savers who had been holding commercial bills directly to reintermediate them through the banking system, adding to sterling M3. The removal of exchange controls by the end of 1979 had previously weakened monetary control by facilitating the creation of offshore bank deposits not measured in sterling M3. With the abolition of the corset, these too came back to the home islands. As interest rates rose in the policy response to unexpectedly high money growth, more money flowed in, and the pound exchange rate took off for the heavens, drawing speculative funds into sterling as an appreciating asset in addition to funds attracted by the high returns. Finally, runs of bad luck and bad judgments early in the Thatcher government, including high public sector pay settlements, large increases in excise taxes and VAT, oil price increases and delayed VAT collections all put pressure on prices as well as on government borrowing and hence on the demand for money, which was as promptly created. The result was a very rapid expansion of sterling M3, and a widespread perception that Mrs. Thatcher was failing by her own monetarist standards.

At the same time, however, Mrs. Thatcher was in fact pursuing a highly deflationary conventional demand policy. Taxes had on balance been held steady, and expenditures had been cut. Interest rates had been raised sharply. High interest rates pushed up the pound exchange

rate, as did the favorable movements of the trade balance due to rising production of North Sea oil, and so depressed foreign demand for British exports. In effect, North Sea oil import substitution "crowded out" foreign sales of British manufacturers. Unemployment soared, and inflation, after rising sharply, subsided after a year back toward the levels prevalent when Mrs. Thatcher's government first took office.

The supreme and delicate irony was that those features of Mrs. Thatcher's policy which gave it a distinctively monetarist quality—the announcement and rigid pursuit of a quantitative monetary objective—and which had been paired with a classical deflationary policy in order to reduce its social costs, in fact increased them. For although the ballooning monetary numbers bore no relationship to the actual state of demand, they destroyed confidence in Mrs. Thatcher's program, undermined the credible threat, and probably generated pressure for higher interest rates and a more severe recession than would otherwise have been the case.

Thus the Thatcher experiment provides two distinct morals for similarly situated and tempted governments. The first is an ambiguous lesson: that disinflation by recession is dangerous, immensely costly, and of immensely uncertain effect. Whether too costly or not is a matter of political judgment, not to say class perspective. The second lesson is clearer: monetarist ideology can under some circumstances add to the cost of a Thatcher-like policy without adding to the benefits, making such ideology undesirable baggage regardless of one's views of the underlying priorities and objectives.

The new administration in Washington came to power acutely aware of the dangers of "Thatcherization"—a term which to them meant disinflation at too great a social and political cost. Such costs are much less tolerable in the American political context where the cooperation of Congress is always uncertain and where the electoral cycle is a short two years. The problem appeared to be to find an effective way to avoid them. In practice, however, the effort which the Administration undertook was designed only to appear to avoid them.

In its design the Reagan economic program, as advertised by its proponents, is divided, like the Thatcher program, into three elements. These are (a) a program of monetary control, aimed at inflation, (b) a menu of "supply-side" measures, allegedly aimed at productivity and growth, (c) an effort to sway expectations and so reduce the costs of disinflation, thus reconciling any conflict between monetary control and growth.

The relative emphasis were however entirely different. Mrs. Thatcher placed "overriding priority" on inflation, and so harked back to the British cultural receptivity, once powerful but long since worn thin, to calls for unity in the face of national crisis. The Reagan program initially lay overwhelming public stress on the promise of growth. This too is a cultural imperative: there is no Dunkirk spirit in the United States, where living standards habitually rise rather than fall in times of adversity such as war. The promise of growth was also, in the short run, unredeemable, which risked enormous public disillusionment with the new government. Whether the promise can be redeemed by long-run performance remains to be seen.

Thus it was that, as the Reagan Administration launched its economic counter-revolution, it did so behind an extraordinary smoke-

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screen of unrealistic economic forecasts and qualitative claims designed to increase public support for the program while concealing its character. Most remarkable were the forecasts for interest rates, for real growth, and for inflation. Interest rates, especially long-term interest rates, would drop immediately following the program's enactment, signaling market confidence in future price stability. Real growth would rise from 1 percent per annum to above 4 percent per annum by 1982 and stay there indefinitely. Inflation would drop by steady progressive stages. Unemployment would fall slowly but without additional pain. Tax cuts would pay for themselves and the budget would balance in 1984.

TABLE 1.—ECONOMIC ASSUMPTIONS OF THE REAGAN PROGRAM, FEB. 18, 1981

	1981	1982	1983	1984
Nominal gross national product (percent change)	11.0	13.3	11.8	10.1
Real gross national product (1972 dollars) (percent change)	1.4	5.2	4.9	4.2
Consumer Price Index (percent change)	10.5	7.2	6.0	5.1
Unemployment (percent change)	7.7	7.0	6.5	6.3
Interest rates (90-day Treasury bills)	11.1	8.9	7.8	7.0
Federal Government deficit (−) or surplus (+), fiscal years, in billions	−$54.5	−$45.0	−$23.0	+$0.5

Note: Percent changes are 4th quarter to 4th quarter.

Source: "America's New Beginning: A Program for Economic Recovery," Washington, Feb. 18, 1981. pp. S. 1, 12.

This prognosis, and particularly that for nominal GNP, was clearly inconsistent with forecasted money growth. According to the Program for Economic Recovery of February 18, 1981, nominal GNP would continue to grow at rates above 9 percent through 1985, while money (M1B) decelerated to one-half its 1980 growth rate of 7.3 percent. This would have required a growth of the income velocity of money of 5 percent per year, far above historical experience. But such inconsistencies, while troubling, were not decisive. Supply-side economics appeared to declare that anything was possible.[3] And the veneer of economic legitimacy which the Reagan Administration was able to bring to its program proved how necessary, but how weak, the constraints previously imposed by traditional economics on policy had been. These had helped in the past to keep the revenue system intact. Without them, a tide of tax-favor-seeking special interests swept through the Congress, parading under their new cloaks of legitimizing theory.

In the aftermath came disillusion. Interest rates rose rather than fell—so much for "rational expectations". The stock, bond, housing and automobile markets naturally collapsed. Growth forecasts were revised down, unemployment forecasts up, to 9 percent or higher by November, 1981. Budget deficits of up to $100 billion per year turned up on the computers, prompting a new round of cuts in social welfare

[3] In testimony before the Joint Economic Committee on February 23, 1981, Dr. Michael K. Evans, the President of Evans Economics and a prominent supply-sider, made the following statement.

"The U.S. economy is about to enter a boom of major proportions beginning in the second half of this year if the Reagan tax and spending cut package is passed. Under this assumption, real GNP would increase at an average rate of better than 5 percent for the next eight quarters, the unemployment rate would fall to 5½ percent by mid–1983, and the rate of inflation would decline from its present level of 12 percent to the 8 to 9 percent range. The major factors which will propel the economy into this orbit will be supply-side oriented."

Committee members reacted skeptically. Representative Frederick W. Richmond (D-N.Y.), told Evans, "You must be out of your mind."

Source: Hearings before the Joint Economic Committee on the 1981 Economic Report of the President, February 23, 1981, pp. 4–5, 38, Washington, GPO, 1981.

programs that the President himself had declared safe. Supply-side economists repaired to the gold standard or went the way of Vietnamese language specialists after 1973. And on stage, the monetarists dropped their smiling masks, revealing that they were and had been in control all along.

In effect, then, the public orientation to growth and restored prosperity served a dual political purpose for the Reagan Administration in its early days. First, it provided a palliative for a distasteful series of budget cuts in programs aimed at the poor and the near-poor. Second, it legitimized a massive reduction in taxes and regulations long sought by the wealthy and by the business lobbies, including near elimination of taxes on inherited wealth and company income, and sharp reductions in taxes on capital income and capital gains. With this accomplished, the growth ideology, by then hardly tenable anyway, no longer served a purpose, and it was discarded. The austerity ideology which followed it attempts to legitimize still further cuts in basic social programs—though whether these will pass Congress remains at time of writing an open question.

Over the longer run, of course, the ultimate direction of Reaganomics remains to be seen. The full impact of the tax reductions and the military boom will be powerfully felt from 1982 onwards. There are two possibilities. Monetary policy could accommodate this fiscal thrust, thereby vindicating the growth promise of the early Reagan months. But the resulting inflation would erode capital values and break faith with Reagan's own constituency in a way which is probably intolerable to them. It is more likely therefore that monetary policy will resist. The result will be a sharp division between the tax-and-spending driven sectors of the economy—armaments and heavy industry—and everything else; coupled with a further sharp transfer of income from interest payers to interest receivers. The effect will be in keeping with the government's class and redistribution orientation, although whether it can be sustained as a political matter is very much in doubt.

The public reputation of monetarism itself was something of an incidental victim of these developments. Within the Administration, monetarists such as Treasury Undersecretary Beryl Sprinkel and Jerry Jordan of the Council of Economic Advisers had all along presented their case consistently and without much obfuscation of the possible social costs. But their views were only intermittently visible to the broader public. And they had been thoroughly submerged in the contrived euphoria of the new supply-side era which prevailed just before the enactment of the tax cut.

So, when the essentially monetarist character of the Administration's macroeconomic policy became clear, driven home by high interest rates over the month of August, the perception of many was that policy had abruptly and brutally changed. Interest groups, such as the national associations of automobile dealers, real estate agents and of homebuilders, which had previously supported the President began to feel an uneasy sense of betrayal. Naturally, it was the monetarist character of the new public policy posture rather than the much-admired President himself that took the brunt of their attack.

Indeed, some conservative business groups, including some most severely damaged by high interest rates, continued to stress their sup-

port of the Regan policy in general. It was only that they wished he would be more "supply-side" and less "monetarist." In some respects, the debate took on an unreal quality, as though "supply-side" and "monetarist" referred to alternative policies which could be substituted for each other, rather than to alternative interpretations of the likely effects for inflation and growth of the same set of policies—with one interpretation being rosy but untenable, and the other tenable but bleak. The dark monetarist soul of the Reagan policy had been concealed for good reason—it promised blood, sweat and tears to a nation with no political stomach for sacrifice and a deep-seated, historically well-justified dislike of politicians who dish it out. Once the collapse of the supply-side scenario forced that soul to be bared, the reaction was understandable. Things quickly arrived at the point where calls (from Jude Wanniski, a prominent supply-sider) for the "public flogging" of Beryl Sprinkel began to appear in the pages of the Wall Street Journal.

At the same time that monetarists were taking public responsibility for economic management in countries where policies were not working, economic managers in countries with better records were taking pains to disassociate their successes from monetarist affiliation. This was most true in the Federal Republic of Germany.

West Germany had been the first major Western nation to publish monetary targets, in 1974. The Federal Republic also has, as all know, an enviable record of success against inflation. So it has been often cited as an exemplar of a monetarism that works. But the case was never clear to the Germans and does not, in fact, hold up.

First, overriding priority in economic policy in Germany is given to stability of economic conditions in general, and not simply to the price level. All aspects of policy and institutional design are brought to bear to achieve this; monetary policy is in a leading but not a dominant role.

Second, the primary utility of monetary targeting is in conveying a signal to banks, to labor and product markets and to the Federal Government of the Bundesbank's intentions. The primary weapon at the Bundesbank's disposal is its credibility, its ability to foster belief in the broadly conceived economic climate it predicts, rather than in an ability to set and hit a particular monetary target. Indeed no store is set by hitting money growth targets in the face of supply shocks or other changes in circumstance.

Third, monetarist ideology plays a small and declining role on the German scene. This is partly due to the juxtaposition of an embarrassing, but not overly damaging, series of failures to hit specified monetary targets despite a successful contemporaneous record against inflation in the first four years of published targeting (1975–1978). More important, it reflects the growing maturity of indigenous thinking about the German economic system, which stresses the organic strengths and weaknesses of German institutions and places little faith in mechanical policy formulae. Thus, despite a recent string of successes in hitting monetary targets (1979–80), the idea of monetarism has come to be viewed by Germans as more synonymous with the highly disruptive, disinflation-at-all-costs policies of Mrs. Thatcher than with their own. And so efforts by monetarists to redeem their sinking public reputation by pointing to Germany increasingly received cold comfort from the Germans themselves.

These assaults on the public reputation and political standing of the monetarists may eventually deal a decisive blow to the political future of monetarist policy-makers. They have, of course, nothing to do with the intellectual arguments for or against the application of monetarist principles to policy. But on this front, too, opponents of monetarism have been gaining ground, aided by events which have dramatically validated some ideas previously considered to be largely academic.

Prof. Benjamin Friedman, in testimony before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, on July 28, 1981, outlined the four principal arguments against the monetarist strategy.

First, the existence of supply-side instabilities in the economy has passed from the realm of academic conjecture into everyday life. Disruptions of oil supplies and sharp changes in oil prices, to take one example, are part of the history of the 1970's. And supply-side shocks destroy the theoretical case for stabilization of the growth rate of the money stock. Such stabilization can only be justified if one seeks maximally rapid transmittal of the shock into output and employment—and there is no reason why such an outcome should be desired.

Second, while the theoretically valid measure of money has always been in dispute, innovations in the private financial sector have made money as a practical matter increasingly difficult to measure. Worse, ongoing innovation makes it undesirable to stipulate which measure of money should be controlled in advance. Yet, as Professor David Laidler has pointed out, to permit discretion in the definition of the variable to which a monetary growth rate is to be applied is tantamount to permitting discretion in the growth rate itself.[4]

Third, the statistical relationship between money growth and inflation has deteriorated sharply in the United States since 1972, and shows no sign of stabilizing. Thus there is no longer good evidence that controlling money is sufficient to control prices, even if there formerly was.

Finally, stability of financial market behavior has also deteriorated. This means that judgments about whether the Federal Reserve has hit its monetary targets depend on highly uncertain estimates of inadequately measured financial market behavior, such as shifts into newly created instruments. As a result, the quality of information about monetary policy performance is seriously degraded.

For these reasons, Benjamin Friedman and other academic critics of monetarism have argued that a compelling *a priori* case in favor of rigid money growth rules no longer exists even if it once did. Their voices are being increasingly heard as experience and dissatisfaction with the record of monetarist policy efforts mounts.

As monetarism has fallen from favor, if not yet from power, a varied and complex set of policy ideas have been advanced to replace it. These ideas have a strong national character. Indeed the striking thing about the emerging debate over economic policy around the world is the lack of an international intellectual framework into which it might fit.

This last observation applies least to the United Kingdom, where the principal opposition voices stem from the venerable tradition of Keynes. These divide into two groups: those favoring continued but

[4] Professor David Laidler, "Monetarism: An Interpretation and an Assessment," The Economic Journal, 91 (March 1981), pp. 23–24.

more flexible deflation, and those favoring reflation combined with various forms of controls.

Those who argue for continued, but more flexible, deflation in Britain today are the traditional conservative Keynesians, many of them erstwhile political allies of Mrs. Thatcher. This view shares with Mrs. Thatcher's government a willingness to use aggregate demand restraint against inflation at the cost of unemployment, but parts company over the more rigid aspects of her policy that give it its peculiarly monetarist flavor. For example, the conservative Keynesians reject the view that inflexible monetary targets help speed the adjustment to lower rates of inflation and reduce its social costs through an expectations effect. This rejection is based on the not unreasonable ground that no evidence for such an effect has yet been found. But without the expectations effect, no special argument can be made for achieving the necessary reduction in aggregate demand exclusively through a rigid monetary targeting procedure. Other policy mixes, such as implied by a combination of higher taxes and lower interest rates, may achieve the same effect with less damage to the capital stock and hence less long-term damage to the British standard of living. And measures such as incomes policy, which the Thatcher government rejects on ideological grounds, are urged as ways in which the determination of government to reduce inflation can be communicated to the wage determination system directly, thereby speeding the process of adjustment and reducing the unemployment otherwise required to get the message across.

The opposition alternative, embodied in the positions taken before the Treasury and Civil Service Committee by the National Institute of Economic and Social Research and the Trades Union Congress,[5] rejects the strategy of deflation outright. These groups share the view that however managed, the long-term costs of deflation to the quality of the British capital stock and the competitiveness of British industry far outweigh any benefits that may accrue against inflation. Better therefore to go for growth, and to combat any accompanying evils—inflation, import penetration, capital flight overseas—with an array of controls over incomes, imports and foreign investment.

A curious feature of the current British debate is that both the deflationist and the reflationist camps have sharply differing views internally over the importance of supply-side measures, and these differences in both cases tend to distinguish the most stringently "Keynesian" viewpoints from the others. Among the deflationists, it is of course Mrs. Thatcher's proponents who carry the "supply-side" banner, arguing for the benefits of a reduced public sector, denationalisations, lower marginal tax rates, and the expectations effect of monetary stolidity. The conservative Keynesians, now in open rebellion, take the more traditional view that social cost, not alleged supply-side benefit, should determine the shape of a deflationary policy. Unlike Mrs. Thatcher, they have fundamentally very little to say to those who point to the long-term decline of British manufacturing and ask what is proposed to be done.

Likewise on the left, it is the most Keynesian viewpoint, that of the Cambridge Economic Policy Group (CEPG), which puts the least

[5] House of Commons, Treasury and Civil Service Committee. Memoranda on Monetary Policy, London, HMSO, July 17, 1980, pp. 147–159 and pp. 168–176.

emphasis on structural reform. The CEPG takes the view that supply-side problems do not arise independently from an insufficiency of demand, and that a strong reflation would simultaneously overcome unemployment and Britain's competitive lag, if it were accompanied in the first instance by strong import controls. By contrast, much of the rest of the reflationist Left argues that significant structural reform of British manufacturing is also required, with measures ranging from new nationalizations, to large-scale overhaul of public infrastructure, to the active promotion of technically advanced industry heading the list. This camp points to the presence of North Sea Oil revenues over the next twenty years or so, and puts its case in terms of a choice between investing that revenue, or consuming it. It is thus the left Keynesian view which finds itself most closely aligned with traditional establishment thinking that structural measures are not required independently of demand-side measures, while Mrs. Thatcher's supply-siders joust with the traditional socialists and social democrats over the type of supply-side measure that both agree, for vastly different reasons, are needed.

The British debate is instructive because the range of economic policy postures under respectable consideration at any time, and especially now, is vastly greater than elsewhere in the world. These run the gamut, from right-wing monetarists and supply-siders, to traditional deflationist Keynesians, to a moderate amalgam of structural reformers and mild Keynesian reflationists, to an ardent group of left Keynesian demand-siders. Elsewhere, the left Keynesian perspective has never been as articulately put forward and, as argued above, the supply-side/monetarist recipe is rapidly losing both its appeal and its hold on the political imagination. That leaves the traditional deflationists, a tired group whose grip is also perceptibly slipping, and the structural reformers. This last group has, of the four, the least well articulated policy program, and the least solid standing within the economics profession of at least the English-speaking world. But, outside the United States and the United Kingdom, its diverse and uncoordinated adherents have long had a decisive say in the economic development of major Western countries, and it is to them that much of the debate is now turning for ways out of the structural adjustment crisis of the late twentieth century.

Japan, Germany and France provide three disparate examples of aggressive structural reform in the last decade. In each case, the motivation has been the same: to restore external balance in the national trade accounts at the highest achievable level of national income, in such a way as to stabilize the value of the currency and so permit favorable terms of trade to exercise a restraining effect on inflation. The mechanism whereby reform is achieved is, however, different in all three countries, and only in France is a structural reform strategy the direct and conscious instrument of an overtly entrepreneurial state.

The Japanese economy stands as a mocking exemplar to economic policymakers of all political persuasions in the rest of the West. Japan has the highest rate of growth of national income, the highest rate of savings and investment, the smallest formal government sector, a high and rising standard of living, a variable but clearly controllable rate of inflation, and an awesome ability to compete internationally across a broad cross-section of bread-and-butter heavy in-

dustries such as steel and automobiles and in the most glamorous fields of modern electronics. All of this is accomplished against a backdrop of near-total dependence on foreign raw materials and energy. And, to rub salt in the wound, it is done without a strong adherence to any of the major economic policy doctrines that dominate the debate in Anglo-Saxon cultures.

Indeed, the truly fascinating thing about Japan from the standpoint of the foreign observer is the paucity of specific, isolable, packageable and exportable economic policy ideas which a study of that country's system affords. Japanese corporate management and labor relations are clearly better; but how does one import so vague a commodity as smooth labor relations? The Japanese wage cycle is annual and coordinated—a definite plus with a counterpart in Germany. Job security in the major firms facilitates the introduction of advanced technologies. But, again, how does one make such a change in the industrial structures of the United Kingdom or the United States? Neat, obvious and imitable principles underlying the Japanese successes are few and far between.

It is not adequate, moreover, to attribute the broad range of Japanese successes to "cultural" phenomena beyond the reach of economic policy. The Japanese themselves reject this view, pointing out that their culture has not changed although their relative economic position has, and noting with amusement that some of the features now regarded as culture-based inducers of success (such as lifetime employment) were singled out only a few years back as prime examples of culture-based sources of backwardness.

Instead, the current enviable position of the Japanese is the result of a cumulative process of development which has its roots as far back as the Second World War and for which public and private institutions, a favorable human capital endowment and historical circumstances bear a balanced responsibility. The public role in this development is embodied institutionally in a series of bodies which command enough respect—and just enough resources—to help set the tone for the implementation of a structural reform whose character is determined essentially within the private sector. These bodies include the Ministry of Finance, the Economic Planning Administration, the Ministry of International Trade and Industry, the Japan Development Bank and the Bank of Japan.

In the early phases of Japanese post-war recovery, the public bodies wielded far more direct clout than they do today. This was true for two important reasons. First, the model to be followed on the path of development—that of the United States—was patently obvious, and so the necessary national investment strategy decisions were relatively easy. And second, the state controlled a major portion of available investible resources. So it was public decisions and public financing that laid the modern Japanese industrial base, its transport network, and which set the stage for the growth of steel, automobiles and the associated rubber, glass and chemical industries.

Neither of the two reasons cited above hold true today, and the direct clout of the public policy bodies has correspondingly fallen. Japan is no longer a backward country trying to emulate a clear developed leader; in many respects it is the leader—and so the prime expertise on what ought to be done next exists largely within the

Japanese private sector. And, as a consequence of past success and deeply ingrained habit, vast resources of domestic savings are available directly to that private sector.

The state has adapted to the new situation by occuping a niche suited to its talents—basically, that of creating the conditions for consensus within the private sector on major initiatives (such as consumer electronics), of lessening though certainly not eliminating (through implicit socialization) the risks for entrepreneurs, and of facilitating adjustment out of sectors (such as textiles) whose competitiveness is in unambiguous decline. Two indigenous metaphors are in occasional use to describe the main features of modern Japanese industrial policy. The first refers to the provision of "mountain shelters," the knowledge of whose existence will induce the private firm to undertake the climb with less encumbering baggage and protective clothing than would otherwise be the case. The second is known as "walking in the wheat nursery." In Japan, wheat plants germinate indoors in mid-winter, at a time when frost causes the earth around the young shoots to swell. Japanese farmers tread carefully between the shoots, pressing the earth down, and so breaking off the weaker roots close to the surface and allowing the stronger, deeper ones to grow.

These impressions suggest that the true key to Japanese success is neither a set of specific policies nor a set of ill-defined cultural happenstances. It is, rather, the fact that Japan has developed over a long period of political stability a smoothly functioning sytsem of business-government and business-labor relations, based on ties of mutual respect and trust built up over a generation. Such a system receives its strongest test in periods, like the present, which impose the requirement for industrial adaptation on a nation's industry. The Japanese system has met the test, and so far stood up well. But it can only be a source of helpless wistful thinking to those other major capitalist powers which failed, over an equally long period, to develop an equally effective means of taking hard adjustment decisions and sharing out their costs.

Will the Japanese pre-eminence continue? Economic miracles have a way of going sour just in time to damage the academic reputations built around their discovery and popularization. In Japan's case there are already certain signs of trouble ahead.

Of these, the most important relate to Japan's position in the structure of international trade, as an importer of raw materials, especially energy, and an exporter of capital intensive manufactures with high income elasticities of demand. As such, Japan was able to capitalize more readily than even other successful Western economies on the long era of inexpensive energy and high growth. And now, Japan is correspondingly more vulnerable to the risks of the converse situation.

With respects to imports, the situation is not entirely symmetric. Japan's total reliance on imported oil placed it at the leading edge of those countries hit hardest by the first oil shock, but Japan was also peculiarly well-suited to adjust rapidly, and so to re-emerge in a position of comparative advantage with respect to other countries, which did not respond as quickly. In automobiles, the high density of Japanese cities and other factors had traditionally dictated small and fuel-

efficient vehicles, and this facilitated an expansion of the Japanese share in even the declining segments of the world auto market. It was far easier for Japanese manufacturers to upgrade their models to the taste of American consumers as those tastes gravitated toward the small car after 1973, than it was for American manufacturers to size down their fleets to meet the same shifting tastes. Similarly, and even more straightforwardly, the Japanese advantage in steel manufacture, built into Japanese plant design and location through the sixties and seventies, translated into an even greater comparative advantage, and hence expansion of world market share, as high costs of imported energy suddenly undermined the unit cost positions of older and less fuel-efficient plants elsewhere.

[It goes without saying, of course, that the situation with respect to a possible disruption in the world trade in energy and raw materials is entirely different. A prolonged cutoff in the flow of oil from the Gulf states would be a major inconvenience to the United States, a misery to Europe, and a catastrophe to Japan. The direct risk of global trade disruption understandably dominates a major part of Japanese foreign and security policy.]

It is the prospect of slower growth in the countries to which Japan exports, principally the United States and Western Europe, which poses the greatest current threat to the future success of the Japanese model, and this is true partly because of Japan's superior short-run adaptation to the world of expensive oil. This threat is political. It is one thing to claim a slowly increasing share of a rising market with increasingly high-quality goods—the traditional Japanese strategy of emphasizing the front edge of the product cycle and products with high income elasticities of demand. It is quite another thing again to use superior social arrangements to generate a continued stream of investment in highly competitive industries in the face of international competitors whose domestic recessions prevent such investment, and then to sell in those competitors' home markets. (In 1974–75, for example, Japanese continued investment in production facilities for the 16K RAM semiconductor chip at a time of severe slump in the American industry's investment; the result is a high and rising Japanese share in this important market segment.) As a result of all these phenomena—in addition to the sometimes minimalist Japanese observance of international trade rules—Japan now faces its most severe challenge from protectionist forces within its Western markets. There are restrictions on automobile exports to the United States, France and elsewhere, elaborate checks on the expansion of its steel markets, and budding threats to its position in the international semiconductor trade. These do not, yet, constitute a major impediment to the material progress of the Japanese. But, given a long and severe crisis, the situation has the potential for a nasty deterioration.

Like Japan, the progress of structural change in Germany owes more to carefully constructed institutional relationships than to deliberate public decisions. Unlike Japan, weaknesses in the network of institutional mechanisms in Germany are already being felt.

The German response to the first oil shock of 1973 was, after a brief period of difficulties, a comparative success. This was due to the smooth functioning of German anti-inflation policy and to the ingenuity and flexibility of German manufacturing industry. Under

pressure from the government and Bundesbank, business absorbed the oil shock without a massive pass-through into prices. Labor, which achieved a high wage settlement in 1974, was brought into line by the resulting profits squeeze and threat of severe unemployment shortly thereafter, and from 1975 wages settlements moderated sharply. Consequently Germany's competitive position improved quickly, as did its external balance, and the economy as a whole recovered smartly through 1979. At the same time, German manufacturers took advantage of the emerging Arab markets, particularly for heavy capital equipment, and of the expanding overseas markets generally for turnkey manufacturing plants. And where general restructuring of specific industries was required to meet changed relative prices or shifts in the composition of demand, such as in steel and shipbuilding, these were effected by the business and financial sectors with relatively little assistance from the state.

By the time of the second oil shock, the measures taken in response to the first by the Germans and by others, especially the Japanese, had had time to work their effects on the German economy, and perhaps to undermine the ability of the coalition of private sector forces to accomplish adjustment without state intervention. The shift toward the export of capital equipment to the oil-producing countries and to the third world ran up against revolution and war in the former countries and the effect of high interest rates and world recession on the investment demand of the latter. At the same time, consumer goods produced overseas in factories designed and manufactured by the Germans began to find an export market in Germany itself. Likewise, Japanese penetration of the German consumer market, particularly autos, shot up, from near nil to 10 percent of sales in 1980 alone. As the economy slipped back into recession, Germans began to wonder whether a second major adjustment in five years was within the capability of German institutions, or whether eventually a massive expansion of state influence, hitherto restricted to such areas as mines, nuclear power, and selected projects like the Airbus, would be required.

In France, by mid-year 1981, the issue of a comparable debate over the role of the state in industrial adjustment was no longer in doubt. The elections of May and June, giving the Presidency and the majority in the Assembly to the Socialist Party, saw to that.

The French elections produced a change in the values and commitments of government which was perhaps greater than any in the industrialized West in recent years. A political movement, the Socialist Party, which had been excluded from power for the entire life of the Fifth Republic suddenly found itself in complete command—*l'alternance* with an astonishing vengeance. In contrast, both the Thatcher government in Britain and the Reagan administration in the United States contain elements of continuity of both stated policy and personnel with governments which were in power as recently as 1974 in Britain and 1977 in the United States.

At the more profound level of political instruments and of action, however, there were substantial elements of continuity in the French transition as well. There had always been a large gap between the laissez-faire and, more recently, even monetarist public ideology of conservative French governments and the interventionist reality of

French economic policy; therefore the change in rhetoric under the new Socialist government was necessarily greater than the change in actions. Indeed, the new government would find that existing instruments of state control, while not adequate to the full task of implementing the Socialist program, were perhaps better suited to that task than the instruments available to any other government of the West. And it would also find, that economic realities do not change in tandem with changes in the composition of the National Assembly; France would continue to be constrained by international circumstances and, as before, it would continue either to adapt its policies to those circumstances or to pay a stiff price in inflation and currency depreciation for the failure to do so.

Neverthless, the Socialist adventure does represent a unique attempt to define a path of development and adaptation for a major Western economy consistent with the values of a political program quite at odds with those values defined elsewhere in the capitalist world by market forces and corporate interest. France is by dint of governmental structure and centralized national economic organization the ideal State for such an adventure; on the other hand the unstable external circumstances of the early 1980's (compared, say, to the 1950's and 1960's) suggest that the international environment is distinctly adverse. In any case, the success or failure of the Socialist strategy in France will no doubt be taken as a harbinger of that strategy's plausibility in much of the rest of the West.

Mitterrandism as it has evolved in the first few months of the new government has, essentially, three elements. These are: (1) a short- to medium-run strategy of macroeconomic stimulus, leading to a larger public share in GNP ultimately as taxes are raised to finance increased expenditures, and combined lately, under stress, with some price controls to ward off the immediate threat of an inflationary spiral; (2) a program of long-term industrial change, designed to create jobs while maintaining external competitiveness and shifting the composition of the French tradeable goods sector in desired ways; and (3) a program of corporate nationalisations and political decentralization designed to alter permanently the balance of economic and political power in France in favor of the Left. The following brief discussion will be concerned only with the first two, economic aspects of this program.

In the short run, macroeconomic perils dominate the headlines and underline the dangers of pursuing economic policies which are significantly out of phase with the trend toward recession in the rest of the world. The government has raised public expenditure levels by 27 percent, and the minimum wage by 10 percent. Taxes are slated to rise, but cannot prevent a significant increase in the public deficit this year. These fiscal measures rendered definitely untenable an exchange value of the franc within the European Monetary System which may have been untenable in any event; the resulting depreciation has added further to pressures on costs. To prevent the sum of these pressures from being passed along in higher prices, and to ease the burden of equilibration that would otherwise fall on interest rates, price controls have been imposed. The short-term result will be a rise in relative wages and a fall in relative profits, and some increase in public employment at the expense of private investment and perhaps private employment as well.

The short-term macroeconomic strategy is not necessarily inconsistent. If the rise in public expenditure is not too abrupt, if taxes rise reasonably quickly to narrow the deficit and without too much pressure on costs, if price controls are enforced, if there is no wage explosion, and if interest rates do not force too rapid a private sector contraction, the government may come through with modest social gains to weigh against only moderate social costs. But the strategy can work, in the sense of leading to sustained growth of real incomes and employment, only if a way is found to sustain investment in world-competitive industries and so offset the squeeze on private profits and incentives. The French financial system, riddled as it is with instruments of selective credit allocation, entrepreneurial persuasion, implicit socialization of risks, and outright credit subsidization, is as well-suited as any to this task. Further nationalisations will also aid in the resolution of this difficulty, by severing the link between current profitability and current investment. And, as the nearly unique French experience of commercially successful nationalized industry shows, it is not impossible that in France the investments so fostered will bear fruit ultimately in self-sustaining enterprises which, like Renault, maintain a fierce day-to-day autonomy from political pressures which are contradictory to the primary mission of production, employment and the generation of wealth.

It is also by no means certain that this will prove to be the case. For the French have entered the same brave new world of industrial policy as the Japanese, in which definite models for the future path of development no longer exist. And in the much smaller, much more closed and in-grown world of the French technocracy, now risking a deep, politically-inspired rift with private progenitors of industrial innovation, there is arguably an even greater risk of misjudgments. The history of Gaullist planning—the direct if unappreciated ancestor of the current strategy—is rich in examples of such misjudged industrial policy objectives, including the Aerotrain, La Villette, Le France, the Concorde, and most recently and massively the dream of a significant share in a significant world market for nuclear electric power generating stations. There were, of course, successes as well, including the armaments industry and such heavy engineering packages as large commercial airports and urban transit systems. Whether the industrial policy planners of the new government, who speak of combining high-technology import-substituting investments (as in textiles) with the development of new job-creating industry for France's export markets, can produce a mix of new industry with a significantly greater proportion of commercial export successes than in the past is an open question, on which may, in the last analysis, hinge the success or failure of Socialist government in France as a whole.

It appears likely that as time passes the Western world will see an increasing articulation of national economic development policies, oriented to the task of sustaining international competitiveness through industrial innovation and internal structural reform. Perhaps a new intellectual synthesis will emerge to provide a uniform ideology for this movement, perhaps not. What is most striking in today's world, however, is the contrast between those countries, notably Japan and France, where action is already underway, and those countries, most notably the United Kingdom and the United States, where as of yet it is not.

U.S. INTERNATIONAL ECONOMIC POLICY IN THE 1980's: SUMMARY

By Albert Mayio*

The contributors of the following essays are international economists from the private sector, government and the quasi-public sector. Their essays cover the fields of trade, international finance, U.S. relations with Japan and with the European community, U.S. policy towards the developing countries, the performance and lessons of the rapidly developing countries, and recent trends in international direct investment.

The essays speak for themselves, and no summary can do them justice. It may be useful to the reader, however, to outline the scope and approach of each of the authors to their topic.

The World Trading System and U.S. Trade Policy in the 1980's

Raymond Ahearn's essay examines the challenges to the world trading system posed by protectionist measures such as "safeguard actions" and "voluntary" restraint agreements. The safeguard actions are measures, intended to be temporary, such as import quotas and increases in tariffs to protect industries threatened by a rapid growth of imports. Sector arrangements are designed to limit competition on a longer-run basis. The multifiber arrangement, for example, limits import growth to textiles and apparel to 6 percent annually, and various other agreements limit exports of Japanese motor vehicles to the United States, the United Kingdom, Italy and France.

Ahearn believes that these departures from the principles of the General Agreement on Tariffs and Trade (GATT) have not as yet seriously threatened the expansion of world trade. However, if these agreements should proliferate as they well might under the more permissive codes of conduct adopted during the Tokyo Round of Multilateral Trade Negotiations (MTN), they could undermine the liberal trading system which has served the world so well.

Under the Reagan administration, U.S. trade policy appears firmly committed to an open international trading system. The administration's economic program seeks to improve U.S. competitiveness through a healthy, dynamic economy, to rely essentially on market forces for adjustment to import competition, and to provide various incentives to export growth.

These measures will require the implementation of the MTN agreements, a new safeguard code under which international rules will become clearer as to the conditions under which countries can impose restrictions to protect their industries, and the negotiation of a reduction of barriers to trade in services and direct foreign investment. This agenda, the monitoring of progress under the MTN, and the

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preferential treatment of imports from developing economies will be major concerns of Congress in the 1980's.

U.S. International Competitiveness

Development since the 1950's in the international accounts of the United States, what they portend, and the various policy options confronting the United States are the subject of Robert Lawrence's article.

Lawrence presents an econometric model of U.S. foreign trade. He finds that for each one percent increase in U.S. GNP, U.S. imports of manufactured goods will increase by 3.1 percent. On the other hand, for each one percent increase in the GNP of the rest of the world, U.S. exports of manufactures will rise by only 1.3 percent. This assymetry implies that for balance to be achieved in U.S. trade in manufactured goods, the growth of U.S. GNP would have to be only a third of the rate of growth of output in the rest of the world or else the relative price of U.S. goods must continuously decline.

But Lawrence uses this model only as a point of departure, not as a predictor of future trends. Since he considers the demand model too simplistic, he then takes into account supply-side factors such as relative U.S. productivity, unit labor costs, the relative degree of utilization of plant capacity in the United States and abroad, relative efficiency of the export sectors of the U.S. and other countries, monetary fiscal, and exchange rate policies, the lagged impact of currency depreciation, technological innovation, delivery times and quality and timeliness of service.

The interaction of all these variables, Lawrence writes, explains why the United States is highly competitive in certain sectors—agricultural goods, chemicals, services and capital goods—and not so competitive in fuels, metals, consumer goods and automobiles. Lawrence finds that no simple theory of U.S. trade performance, such as one based only on changes in relative prices and incomes is satisfactory.

In the last part of his essay, Lawrence examines various options open to the United States to deal with the substantial trade deficits expected in the early 1980's. He concludes that the most effective policy would be to improve overall price performance. Reducing relative costs requires fiscal and monetary measures to check inflation and a policy that encourages adjustment rather than protection of ailing industries.

United States-Japan Trade

In his essay on United States-Japan trade relations, Dick Nanto finds that on the whole the two countries are adjusting to their changing relative economic strengths. In the area of agricultural, energy and trade policy, progress may be less apparent given Japan's great dependence on imported food and energy and its need to export. In the area of foreign trade, Nanto finds that Japan is becoming a more open economy, although various import restrictions, especially in agriculture, persist. He notes several actions by Japan to ease friction with the United States and joint efforts to iron out issues, most recently in its voluntary decision to limit exports of automobiles to the United States.

Japan's growing trade surplus, partly a result of the strong U.S. dollar in 1980–81, is stimulating protectionist pressures in the United

States. An appreciation of the yen with respect to the dollar would weaken the Japanese trade balance with the United States. Perhaps the most effective and efficient way to meet this problem would be for Japan to adopt expansionary domestic economic policies. However, with a government deficit equal to 5 percent of GNP, compared to 2½ percent for the United States, the Japanese are reluctant to increase their deficit.

International Direct Investment in World Market Economics

In her essay, Dorothy Christelow discusses the main trends in international direct investment, the underlying changes in the world economy responsible for these trends, and the policies toward foreign investment of both home countries and host countries, including the United States.

Christelow presents the case for and against international direct investment from the point of view of both source and host country. She attributes the fall in real international direct investment growth, from 9 percent annually in the 1960's to 5 percent in 1970–78, primarily to the economic slowdown in the industrial countries but also to changes in national investment policies in both host and source countries.

Among the developed countries, Japan has moved the furthest in encouraging outward investment in resource industries and in manufacturing industries in low-wage countries. The United States, which for years has been in the forefront in promoting liberal foreign investment policies, has recently shown signs of becoming more interventionist. This change is the result in part of the fact that the inward investment continues to grow faster than our investment abroad and, the result in part of Canada's increasingly discriminatory treatment of U.S. firms.

The developing countries have followed ambivalent policies. On the one hand, they have encouraged foreign investment in their manufacturing sector. On the other hand, they have increasingly insisted on local participation and they have discouraged foreign investment in resource industries or nationalized foreign-owned firms in this sector. The growing importance of foreign investment in the United States, Christelow concludes, should deepen U.S. understanding of host-country problems and thereby enhance U.S. effectiveness in negotiating international investment codes which would minimize intervention while recognizing national interests.

The Evolution of the International Monetary System

In his essay, Henry Wallich sharply rejects the view that the international monetary system needs basic reform. On the contrary, he insists that the system is evolving well as a result of both international official actions and innovations by private financial institutions.

Wallich's argument rests on the success of the system in maintaining growth in world trade and in international capital flows despite the severe shocks of the oil crisis and the impact of high inflation. The key elements in the success of the system have been the influence of the International Monetary Fund, Wallich believes, in maintaining a certain international discipline over national economic policies, in

the efficacy of flexible exchange rates, and in the growth of private capital flows.

Wallich reviews the strengths and weaknesses of alternatives to the dollar as the key reserve asset. These are the Special Drawing Right (SDR) of the International Monetary Fund and its proposed substitution account, a multicurrency reserve system, and the gold standard.

In his view, of the three atlernatives, the SDR offers the best prospects of providing the framework of international discipline and cooperation needed to expand trade and international capital flows. However, the impasse between developing and industrial countries over how and in what volume SDR's should be allocated, and the impasse between the United States and the other industrial countries over sharing the risks and burdens of the SDR have halted the expansion of the SDR system. Meanwhile, the current system—a multicurrency one—is working well despite its potential instability.

Recycling and the Debt Problems of Developing Countries

William Cline directs attention in his essay to the problem caused by the large external debt and growing financial needs of the developing countries. This is the danger that the developing countries may be forced to reduce their economic growth either because they can no longer find the financing necessary to obtain needed imports or because their export markets in the industrial countries have weakened.

While Cline does not categorically exclude the possibility of a world financial crisis caused by large-scale defaults by over-extended countries and the devastating impact of these on private banks, he finds that very few of the major borrowers seem to be prime candidates for debt rescheduling, let alone default.

Since the many private financial institutions in the industrial countries have a relatively large percentage of their loans tied up in developing countries, the prospects are slim that they can continue to furnish the growing amounts needed by the developing countries. If the international financial institutions prove unable to furnish increased credit to the developing countries, the latter will have no alternative but to cut imports and domestic output. Apart from the serious internal consequences of these cuts, the result could be an intensification of worldwide reecssionary pressures.

Cline presents a number of options to prevent a wide-spread cutback in LDC growth. These include increased bilateral and multilateral economic assistance, increasing the lending capacity of the World Bank and the IMF, expansion of the compensatory financing facility of the IMF to meet increased debt serving needs caused by high interest rates, and the encouragement of direct lending to the LDC's of OPEC countries with financial surpluses.

U.S. Policy Towards the South

In his essay, Sidney Weintraub analyzes the impasse in North-South discussions. To the spokesmen for the developing countries, the reason for the impasse is the stubborn refusal of the industrialized countries to recognize the justice of their demands for greater trade concessions and larger, and assured, economic aid. The remedy, in the eyes of third

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world spokesmen, is the New International Economic Order, a euphemism, Weintraub implies, for an international economic system dominated by the developing countries. The Brandt Commission, headed by former German Chancellor Willy Brandt and consisting of several other prominent statesmen from the industrialized countries, fully supports the third world position.

Weintraub believes the Brandt report is unhelpful in that its approach provides no bridge between the competing agendas of the North and South. The report is bereft of appreciation of how much has been accomplished under the present trading system. It fails to differentiate among the needs of countries at varying levels of development. And, finally, it is politically naive in proposing that the North should allow its decisions over trade and aid policy to be pre-empted by the South.

Weintraub holds that not only are the third world positions and the Brandt report unrealistic, they are also irrelevant and probably counterproductive. In order to maintain unity, the organizations representing the developing countries accept almost all the demands of their members as part of their agenda, thus creating an overload of demands made upon the industrialized countries. Second, the developing countries offer no quid pro quo. Third, and most important, the South wants the North to yield power to it so that it can dictate the conditions of international financing, trade and aid.

Under the circumstances the best policy for the United States, Weintraub argues, is to be true to its own principles. These helped create the present international order under which the developed and developing countries have benefited greatly. Over the last 35 years: the rate of economic growth of the middle income developing countries has not only been greater than that of the developed countries, but higher for a significant group of countries over a longer period than ever before.

Weintraub sees the greatest danger to the present international economic order not in the pressure of the developing countries for a new international economic system but in protectionism and in the failure to provide adequate levels of concessional resources to countries as yet unable to take advantage of "the international rules of the game in the market place."

The Newly Industrializing Countries: Experience and Lessons

Not least of the results of the 35 years of effort to liberalize world trade has been the rapid economic growth of a number of developing countries, the so-called "newly industrializing countries" (NIC's). The reasons for the success of these countries in achieving high sustained economic growth and the implications for U.S. policy are the topics of Anne Krueger's essay.

There is no agreed-upon definition of what constitutes a NIC or what countries should be included in this category. Krueger employs a strict definition which eliminates some of the more advanced developing countries such as Argentina, Yugoslavia, Mexico and India. The five countries and city states which meet her definition are Brazil, Hong Kong, South Korea, Singapore and Taiwan.

In all five cases, Krueger writes, domestic producers were not only provided incentives for exporting—financial and exchange rate policies geared to growth and exporting—but also given credible assurances that these policies would be adhered to in the future. A strong political leadership committed to an export-oriented strategy was the common critical element in the success stories.

Foreign aid was essential in the development of the NICs, Krueger writes, because in the early stage of development, countries cannot resort to private capital markets, and private foreign investment cannot take the place of the range of infrastructural and technical assistance programs which official development assistance provides.

TRADE AND INVESTMENT

U.S. TRADE POLICY IN THE 1980's

By Raymond Ahearn *

I. Summary

The steady reduction in tariffs and other trade barriers contributed to the strong expansion of world trade and to rapid economic growth and higher real incomes throughout the world since the end of World War II. In the aftermath of the 1973 oil price increase, fears were expressed that these gains would be threatened by a retreat to protectionism. However, this fear has not materialized.

Nevertheless, world trade in textiles and apparel and steel is quite restrictive and pose serious obstacles to continued trade expansion. New threats of trade restrictions loom in the background.

The Tokyo Round of multilateral trade negotiations (MTN), which were concluded in 1979 after more than five years of laborious negotiations, reduced developed country tariffs by one-third. This will bring average tariffs down to very low levels (3 to 4 percent) by 1987. Thus, tariffs in general are no longer the primary trade barrier. Nontariff barriers, which the Tokyo Round addressed comprehensively for the first time ever, remain the most important trade restrictions. These barriers will be influenced increasingly by the new trading rules established in the Tokyo Round.

The new rules or codes of conduct are more extensive and should provide the basis for further trade expansion, but they also create a more complex and less unified trading system. Countries as well as sectors are treated differently.

Whether the new codes will be able to provide the discipline and predictability necessary to maintain a liberal world trading system will depend on the interaction of various legal-institutional, economic, and political factors. The effects of the spread of conditional most-favored-nation (MFN) treatment which legitimizes discriminatory policies among nations will shape the trading system in important ways. Economic factors, particularly slow growth, erode support for liberal trade policies. The more even distribution of world military and commercial power today also has important consequences for the world trading system.

Enforcement of the new trading rules remains critical if a greater degree of certainty and fairness is to govern international trade. If all countries come to assume international trade obligations commensurate

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with their economic position, the world trade system can continue to contribute importantly to world prosperity and peace.

Against this background U.S. trade policy confronts a number of important domestic and international issues in the 1980's. Policies adopted will influence the U.S. position in domestic and foreign markets and the world trading system.

The Reagan Administration's economic recovery plan attempts to improve U.S. competitiveness through restoration of a healthy, dynamic economy. High interest rates, an unintended consequence of current economic policy, however, have contributed to a strengthening of the value of the dollar to a level that will reduce the competitiveness of U.S. exports during 1981 and beyond.

The Reagan Administration has also announced its intention to rely substantially on market forces to determine its response to import adjustment problems. Import restrictions will be rarely used.

The removal or modification of export disincentives will remain a continuing concern of both the Reagan Administration and Congress. Attempts will also be made to provide more positive support to U.S. exporters through provision of tax incentives, export financing, and informational and marketing programs.

Internationally, a major task involves the implementation of the MTN agreements. A perception on the part of some observers of limited and slow progress will be examined by Congressional trade committees in the 97th Congress. Efforts to negotiate a safeguards code, which would delineate international rules under which countries can impose restrictions to protect domestic industries, will continue. The United States will also attempt to negotiate a reduction of barriers to international trade in services and foreign direct investment, two areas of large and increasing importance to the U.S. economic position. Decisions providing for differential treatment of developing countries will become more numerous and important in the coming years. Prospects for increased trade with non-market countries will continue to be conditioned by political considerations under the Reagan Administration.

II. Challenges to the World Trading System

The postwar world trading system developed on the basis of a common desire to reduce trade barriers and to avoid a return to the kinds of restrictions and discriminatory trading relationships that characterized the 1920's and 1930's. The establishment of the General Agreement on Tariffs and Trade (GATT) in 1947 provided an institutional framework and a set of rules and principles for multi-lateral efforts to liberalize trade. The unconditional most-favored-nation (MFN) principle, by which one country promises to extend to other countries the most favorable concessions it negotiates with any third country, served the postwar trading systems well by facilitating the reduction of high tariff levels.

The steady postwar success in reducing tariffs helped to expand world trade which, in turn, contributed to increased economic growth. Between 1953 and 1960, when tariffs and other import restrictions were reduced markedly, world export volume increased by an average annual rate of 7.6 percent while world production increased by 5.2 percent. The rate of growth of trade exceeded the rate of growth of

production by an even wider margin (7 percent to 3.6 percent) for developed countries alone.

The relationship between the growth of trade and the growth of output continued between 1960 and 1973. World exports during this period grew by 8.5 percent and world output grew by 6 percent. Again the rate of growth of trade exceeded the rate of economic growth by an even wider margin (8.8 percent to 4.8 percent) for developed countries. During this period, the Dillon and Kennedy rounds of trade negotiations were completed. The Kennedy Round reduced tariffs on industrial products by an average of one-third. At the same time, the growth of world trade was supported by the elimination of tariffs within the European Community (EC). These postwar results created a widely held view that a liberal world trading system can contribute substantially to important societal goals; namely rapid economic growth and higher real incomes and wages.

From 1973 to 1978, in the aftermath of the OPEC oil price increases, world trade increased only a little faster than world production and at a slower rate (4 percent trade growth and 3.5 percent economic growth). During this period experts frequently cautioned that the world trading system was on a dangerous course. Fears that the open world trading system would break down in the face of increased pressures for protectionism were highlighted by several influential publications. The GATT secretariat in 1977 estimated that 3 to 5 percent of world trade or some $30 to $50 billion was being adversely affected by import restrictions introduced by developed countries between 1973–77. A study by the International Monetary Fund in 1978 also found an increase in protectionist actions.[1]

More recent studies, however, have indicated that the protectionist actions taken in the past seven years have not posed a great threat to the expansion of world trade.[2] One trade authority even argues that the trend toward protectionism has not continued and in some cases has been reversed.[3] A review of the protectionist actions taken by the major industrial countries (the United States, the European Community and Japan) that account for over 55 percent of world trade follows.

Protectionist Actions of Major Industrial Countries

The primary protectionist actions which challenge a liberal trade system are "safeguards" actions and "sector agreements." Both are measures designed to limit fair and competitive imports directly. Safeguard actions are trade restrictions such as import quotas or higher tariffs imposed to protect industries that are suddenly threatened by a rapid growth of imports. They are supposed to be temporary and are permitted under Article XIX of the GATT.

In recent years, Article XIX (which allows the exporting country to claim compensation and allows retaliation if compensation is not provided) has not been much used. Instead countries have achieved restrictions through orderly marketing agreements (OMA's) or voluntary restraint agreements (VRA's). In addition to being outside the GATT's rules, these measures discriminate against particular coun-

[1] International Monetary Fund. Trade and Payments Division. The Rise of Protectionism. Washington. D.C. 1978.

[2] Linda M. Gard and James Reidal. "Safeguard Protection of Industry in Developed Countries: Assessment of the Implications for Developed Countries." Preliminary report issued October 1979 by World Bank for discussion purposes.

[3] Bela Balassa. "The Tokyo Round and Developing Countries," Journal of World Trade Law. March: April 1980.

tries, usually the most efficient producers. Other types of agreements also avoid the discipline of the marketplace through quotas and other restrictive practices. Textiles and apparel is the sector most affected, but steel, agricultural products and raw materials are also affected to varying degrees.

SAFEGUARD ACTIONS

Both the United States and the EC have made selective and moderate use of safeguard actions, while Japan has headed in the direction of increased trade liberalization.[4] United States safeguard actions to impose quantitative restrictions or higher tariffs are authorized by section 201 of the Trade Act of 1974. From April 1975 through November 1980, 44 investigations were undertaken by the International Trade Commission (ITC). The Commission found injury and recommended to the President increased trade restrictions in 23 of the cases. The highly publicized billion dollar import relief case for the U.S. auto industry is the most recent instance in which the Commission did not find injury. The President, however, decides whether to grant import relief, and did so in only 9 of the 23 cases sent to him. In the nine cases the President has provided import relief, three remedies have entailed an orderly marketing arrangement, one case a global quota, and the five remaining cases, increased tariffs. Tariff remedies, which are neither as restrictive and inefficient as quotas and are not discriminatory, have been the favored remedy in most recent cases.

From 1973 to February 1980, the EC has taken 18 safeguard actions. In contrast to the U.S. policy of relying on increased tariffs or OMA's as a remedy, the EC has relied primarily on quantitative restrictions. The protection has been discriminatory, with Japan and other East Asian countries the object of most of the restrictions.[5]

Voluntary and most often non-publicized restrictive agreements are more prevalent in the EC than in the United States. For example, Italy imposes strict quotas on Japan auto imports, the U.K. tries to keep auto imports below 11 percent of its market; and France too limits Japanese auto imports.[6] It is also reported that South Korean exports are subject to European country restraint agreements on toys, umbrellas, radios and footwear.[7] Given the secrecy of most of these agreements, it is most difficult to assess their magnitude.

Japan is a protectionist enigma compared to the United States and the EC. Judged solely on the basis of overt government policies to restrict imports (tariffs, quantitative restrictions, and sector arrangements) most analysts would agree that Japan has been moving away from protectionist policies more consistently than other industrialized countries in recent years. However, if a more expansive (and some would argue unfair) definition of nontariff barriers relating to general features of Japanese society and culture is utilized, then Japan's market can be characterized as less open than the U.S. or EC markets.[8]

On paper, Japan is the only industrialized country that has consistently taken trade actions toward greater liberalization since 1974. In

[4] Gard and Reidel, op. cit., p. 16.
[5] Gard and Reidel, op. cit., p. 11.
[6] World Business Weekly, Oct. 27, 1980, p. 64–65.
[7] U.S. Federal Trade Commission staff report on Effects of Restrictions on United States Imports: Five Case Studies and Theory. Washington, D.C., June 1980, p. 177.
[8] Eugene J. Kaplan, United States-Japan Trade Council. Japan's tariff and nontariff barriers: the perception gap. 1979.

the tariff area, as a result of the Tokyo Round, Japan's trade weighted tariff will be around 3 percent ad valorem by 1987, a level slightly lower than that of the United States or the EC. In terms of quantitative restrictions, Japan has since the mid-1960s progressively liberalized its quotas on 27 mostly agricultural products. Product standards and government procurement policies are the remaining traditional nontariff areas that can be liberalized substantially. Both are subject to international agreements and ongoing negotiations.[9]

Assertions that loosely defined barriers associated with Japanese culture and institutions act as significant trade barriers are more difficult to assess. Administrative guidance and the distribution system are the two most frequently cited nontariff barriers. Administrative guidance generally means some kind of bureaucratic pressure to get Japanese importers to limit purchases of particular commodities or to switch from foreign to domestic sources. Documentation of administrative guidance affecting actual import decisions is difficult to obtain.

Japan's internal distribution system, primarily for consumer products, confronts a foreign supplier with many layers of small and specialized retail establishments. Adapting to the system entails considerable effort, money and perseverance. Although it is a complicated distribution system in many ways favoring obligations and loyalties to domestic suppliers, and presents serious commercial obstacles, it probably does not warrant being called a nontariff barrier because it is not governmentally determined. It is expected that the distribution system will become less of a barrier over time as economic conditions in Japan change, bringing changes in a system which is inherently costly and inefficient.[10]

SECTOR ARRANGEMENTS

Sector arrangements limiting competition in textiles and apparel and steel appear to be more significant trade barriers in both the United States and the EC than safeguard actions. International trade in textiles and apparel is regulated by the GATT-sanctioned Multifiber Arrangement (MFA). The MFA provides a general framework for the negotiation of bilateral quotas between importing and exporting countries. The primary provision of the MFA limits import growth to 6 percent on a yearly basis. Both the United States and EC have extensive agreements with developing countries covering a large number of product categories. Additional protection is provided by relatively high tariffs.

Differing views are heard on the importance of the MFA. It has been described by GATT researchers as an "important precedent in leading to the breakdown of the world commercial system." [11] Supporters maintain that it provides order and stability to an area that would become choatic without managed trade. That the MFA has been successful in limiting imports is indicated by two facts. Between 1971 and 1979, when other imports were rising, the quantity of textile imports in the United States declined by 8 percent while the quantity of apparel imports grew by only 2.7 percent.[12] These figures, of course,

[9] See the chapter on "United States-Japan Trade Relations" by Dick Nanto in this volume.
[10] Kaplan, op. cit., p. 16.
[11] General Agreement on Tariffs and Trade. "Trade Liberalization, Protectionism and Interdependence." Geneva, 1977, p. 48.
[12] Source: Commerce Department, Office of Textile and Apparel.

mask significant changes in many individual product categories. In addition, foreign imports represent a smaller share of domestic consumption than do imports of many other import-sensitive industries. In 1979, for example, imports of all textile products including apparel constituted 10.5 percent of the market while apparel alone made up about 15 percent of the market.[13] This compares with a 50 percent foreign market share in footwear, 28 percent share in automobiles and 17 percent share in steel.

Textile-exporting developing countries have been dissatisfied with the protocol of the MFA renegotiated in 1977. The protocol introduced the concept of "jointly agreed reasonable departures" and has resulted in growth rates much lower than the "at least 6 percent" contained in the original MFA. Despite developing country dissatisfaction, the MFA was extended for 4 years and 7 months at the end of 1981. A new protocol, which provides for MFA departures against major developing country suppliers will be tested during 1982.

The EC, whose textile industry presently is suffering substantial financial and employment losses, has imposed even tighter restrictions on developing country exports than the United States. Not only is the European industry suffering, but press reports indicate that it is pressuring the EC to apply tighter restrictions along the lines of the MFA against U.S. textile exports which soared in 1980. Already the EC has imposed antidumping duties on U.S. acrylic and polyester yarns and the United States has threatened to increase tariffs on EC woolen goods and artificial yarns.[14] Unless durable solutions are found, taking into account both the aspirations of developing countries that possess a comparative advantage in many textile and apparel products and the problems of adjustment in developed countries, world trade in textiles could become much more restrictive.

Steel is a second sector in which pressures for protection have occurred over the past decade. From 1969 to 1974 voluntary restraint agreements were in effect between European and Japanese producers and the United States. In 1976 the United States negotiated an orderly marketing agreement with Japan covering specialty steel items and imposed unilateral quotas on other specialty steel suppliers. In December 1977 the United States introduced a system of trigger prices in response to charges by the domestic industry that foreign producers were selling at less than fair value in the United States. Although the trigger price mechanism, pegged to Japan's costs of production, was intended to be a monitoring device for the more efficient administration of the U.S. antidumping statute, many critics argued that its effect was to set minimum price levels for both imported and domestic steel.

On March 18, 1980, U.S. Steel brought an antidumping suit against 16 steelmakers in seven countries of the European Community. The Carter Administration maintained that it could not administer the trigger price mechanism simultaneously with U.S. Steel's wholesale dumping claim and proceeded to suspend the trigger price mechanism.[15]

After months of high-level negotiations with U.S. Steel and with representatives of the EC, the Administration announced on September 30, 1980 a package of assistance to the steel industry which in-

[13] Textile Organon, various issues.
[14] Business Week. Nov. 17, 1980, p. 58.
[15] Driscoll, David. "Steel and the European Community: The Protection Issue." Congressional Research Service Issue Brief No. 80061.

cludes a reimposition of the trigger price mechanism at a 12 percent higher level. The 12 percent increase is said to translate into an average increase of about $48 a ton for both imported and domestic steel, costing consumers an extra $4 billion a year.[16] An additional feature of the new program covers import surges. Surges in the volume of steel imported into the United States that give foreign steelmakers more than 13.7 percent of a particular market at any time the domestic industry is operating below 87 percent of capacity will be scrutinized immediately by the Department of Commerce for possible dumping violations. If the volume of imports exceeds 15.2 percent of domestic consumption when capacity utilization is less than 87 percent, a more thorough investigation is required. Although the surge feature is only intended to involve strict monitoring followed by application of the antidumping duty laws, congressional critics have expressed fears that it might act as an effective quantitative limitation for which there is no legislative mandate.[17]

The EC has also extensively regulated international trade in steel. Beginning in 1974, the EC negotiated bilateral restraint agreements with most foreign suppliers. The quotas were renegotiated as recently as 1979 with 13 of the 15 suppliers including Japan, Austria, Finland, Norway, Spain and Eastern Bloc countries, South Africa and Brazil were the two suppliers excluded completely from the European market, allegedly for political reasons.[18] The EC has also instituted a system of minimum prices for both imported steel and domestically produced products, and has imposed production cutbacks.

An International Steel Committee has been established within the Organization for Economic Cooperation and Development (OECD). Its task is to monitor trends in worldwide production, investment and trade. Critics argue that it may serve as a vehicle to divide up world markets and further regulate international trade.[19] How governments deal with the difficult problems of falling demand, excess capacity, and a potential loss of jobs on the one hand and the economic cost of restricted trade on the other hand, will continue to be a critical challenge in the 1980's.

ASSESSING PROTECTIONIST ACTIONS

Based on an evaluation of official government actions of major developed countries to limit directly foreign competition, no great threat to trade expansion is evidenced. The United States and EC have made selective and moderate use of safeguard actions while Japan has moved steadily in the direction of increased trade liberalization.[20] Official actions in the textiles and apparel sector, however, pose serious challenges to continued trade expansion. International trade in steel also appears to be subject to increased regulation. Concern can also be expressed regarding the growth of trade friction and problems among the largest trading powers—the United States, the EC, and Japan—over trade in steel, textiles, and autos. To prevent these and other trade issues from escalating into major international disputes, the three

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[16] Congressional Record, Oct. 2, 1980. E4770. Statement of Congressman Bill Frenzel.
[17] Ibid.
[18] Source: Phone conversation with steel industry analyst at the International Trade Commission, October 29, 1980.
[19] Federal Trade Commission, op. cit., p. 198.
[20] Gard and Reidel, op. cit., p. 16.

trading powers agreed at the Ottawa Summit to establish an early-warning consultative arrangement.[21]

It should be emphasized that this review of protectionist actions does not include countervailing duty and antidumping actions. Although they are legal reactions to unfair trade practices, they are sometimes utilized in a protectionist manner. The evaluation also does not include the difficult area of agricultural trade where domestic policies pose serious trade barriers. Nor does the review assess the recent negotiations to regulate trade in such commodities as sugar, tin, copper, coffee, and cotton, among others. A more extensive review would also incorporate trends in government policies to help domestic producers at the expense of foreign producers. These aids (e.g., subsidies, government procurement policies, and product standards) will increasingly be influenced by the new trading rules established in the Tokyo Round of trade negotiations. Although it will be several years before a serious evaluation of the codes developed to deal with government created nontariff barriers (NTB's) can be made, the codes on paper establish the foundation of a new world trading order.

Post-Tokyo Round World Trading Rules

The Tokyo Round codes revise GATT rules in some areas and introduce new trading rules in others. Altogether seven NTB codes were negotiated—Subsidies-countervailing, Antidumping, Standards, Government Procurement, Customs Valuation, Import Licensing and Civil Aircraft. These codes, together with a Framework Agreement legitimizing special and differential treatment for developing countries and two agricultural arrangements on meat and dairy products, constitute a new set of world trading rules.

These codes provide the basis for a very different system of world trade. Unlike the postwar system which utilized the unconditional MFN principle to pass on tariff reductions to nonparticipating countries on a non-discriminatory basis, the new trading agreements sanction discrimination through inclusion of conditional MFN provisions in each of the codes. This simply means that the benefits of each code are extended only to those countries that sign the codes and agree to undertake the prescribed obligations.

Conditional MFN or discrimination was a necessary condition in negotiating the codes. Without conditional MFN, further trade liberalization would not have been possible. Sovereign nations willing to accept international discipline today demand that it apply reciprocally. In the earlier era when the benefits of tariff reductions were passed on to nonparticipants, competition for world markets was not as intense and countries receiving a "free ride" were not serious competitors. And, of course, reductions of tariffs benefitted the importing as well as the exporting country.

The codes also vary in the degree to which they conform with the original GATT view that a liberal trade system involves rules to minimize government involvement in the marketplace. Some of the codes, particularly the agricultural arrangements, the dispute-settlement procedures of each of the codes, and portions of the subsidies-countervailing code, increase the role of government in managing or

[21] Farnsworth, Clyde H. 3-Way Forums Set As Way to Defuse Tensions in Trade. New York Times, August 12, 1981, p. 1.

directing international trade. The majority of the codes (Government Procurement, Standards, Customs Valuation, and Civil Aircraft), however, move in the direction of limiting governmental interference in the marketplace. On balance though, if properly implemented, the codes should provide a strong foundation for further expansion of trade.[22]

To date most major developed countries have signed all or some of the codes, but very few developing countries have signed any of the codes. Although efforts are being made to obtain more developing country participation in the new trading system, the failure to date undermines hopes of applying the agreements on a worldwide basis and of maintaining a unified trading system.[23]

According to spokesmen for the developing countries, a primary reason for not participating in the new codes is the insufficient preferential treatment accorded developing countries.[24] The codes do, however, provide various special benefits. For example, in the subsidies and countervailing duty code, developing countries are provided the right to grant export subsidies and excluded from actions against them if their subsidies adversely affect the exports of other signatories in third country markets. In return, developing countries are subject to vague obligations. Under the Government Procurement Code, developing countries can compete for developed country purchases of goods while being subject to less stringent obligations. Furthermore, the poorest developing countries may benefit from the code without incurring any obligations whatsoever. A legal basis for providing preferential treatment for developing countries is codified in the Framework Agreement along with a "graduation" clause which calls for developing countries to accept greater obligations as their economic development warrants.

The inevitable effect of the new codes is the creation of a much more complex and less unified world trading system. Countries and sectors are treated differently. All of this should not be too surprising. As GATT membership has grown fourfold in over thirty years, world trade has increasingly been transacted among different countries with different philosophies, different economic structures and at different stages of economic development. Whether the new codes will be able to provide the discipline and predictability necessary to maintain a liberal world trading system will depend on the interaction of various legal-institutional, economic, and political factors influencing government actions.

Factors Conditioning the World Trading System

LEGAL-INSTITUTIONAL

An important legal-institutional factor affecting the liberal trade environment is the spread of the conditional MFN principle to a much larger volume of world trade. Conditional MFN means that only code signatories will obtain the benefits of the new trading rules. Critics

[22] John J. Jackson, "MTN and the Legal Institutions of International Trade," U.S. Congress, Senate Finance Committee, June 1979, p. 5.

[23] In addition to the problem of developing country participation, great uncertainty exists concerning the extent to which communist countries, including China, will be integrated into the world trading system.

[24] Thomas R. Graham, "Revolution in Trade Politics," Foreign Policy, Summer 1979, p. 58.

believe that this development may open the way for selective bilateral measures such as quotas applied against the exports of a single supplier.[25] More optimistic observers emphasize that today's trade barriers necessitate a form of conditional MFN if trade liberalization is to proceed.

The more widespread use of conditional MFN is bound to create trade disputes at least in the short run. The United States and India already have had differences over the subsidies-countervailing duty code. The Carter Administration's September 1980 decision to deny India the right to an injury test under the U.S. countervailing duty code has caused Indian Prime Minister Indira Gandhi to remark that "rich men's clubs take care of their own members and we are told to fend for ourselves." India, which is a member of GATT and a signatory to the subsidies-countervailing code, challenged the U.S. decision on the basis of GATT's Article I which requires that unconditional MFN treatment be accorded to all signatories. The Carter Administration's decision was based on India's unwillingness to commit itself to a phase-out of its export subsidies over a period of time. The fact that the United States did not require a similar commitment from Pakistan and Uruguay no doubt played a role in India's reaction. Hence, the seeds of friction are planted when countries accord differential treatment from one to the next.

Supporters of a growing system of conditional MFN in which concessions are extended only in return for concessions received believe that it will put pressure on governments to follow open trading policies and to participate in the new trading system. As indicated, participation of developing countries has been disappointnig but the early 1980's could simply represent a preliminary phase. In time the gains from participation may become more self-evident to developing countries and participation will increase. In the interim, the various codes covering diverse subject matters will have varied and uneven membership.

Whether disputes such as the U.S.-Indian one can be settled on the basis of the merits of the case through the GATT dispute-settlement process will be critical to increasing confidence and adherence in the new trading rules. Many developing countries remain cynical and discouraged about the fairness and benefits of the world trading system. If early disputes appear to be settled on the basis of the relative size of the countries involved or the strength of their domestic political interestes, confidence in the system will be undermined and increased participation of developing countries will be less likely.[26]

ECONOMIC FACTORS

Economic considerations also both challenge and support an open world trading system. Difficult economic times tend to erode support for free trade policies and create an uncertain environment for international trade. During periods of high inflation and unemployment, rising energy costs and sluggish investment, imports are often singled out as having a direct impact of domestic producers and workers. What

[25] A more drastic view sees conditional MFN spreading to the tariff area where only the strongest and largest would survive. See Gerard and Victoria Curzon, "The Multi-Tier GATT System," in Hieronymi, Otto, ed., the New Economic Nationalism, Macmillan Press, 1980.

[26] Graham, op. cit., p. 58.

needs to be remembered, however, is that international trade is not necessarily the cause of these economic problems. On the contrary, increased trade can contribute importantly to fighting inflation through greater competition and acts as an important catalyst in the expansion of the world economy. In particular, international trade is not the primary cause of unemployment in the U.S. either. Shifts in consumer demand and changes in productivity account for a more substantial portion of job losses than does trade.[27] For example, it is estimated that a hypothetical increase in U.S. imports totaling $20 billion in 1976 would have led to approximately 720,000 job losses. This is less than 10 percent of the estimated 10 million workers laid off for all reasons during the course of 1976.[28]

Although imports play only a minor role in determining overall employment in the U.S. domestic economy, they can present difficult political and human problems. While the benefits of trade expansion are diffused over the entire U.S. economy, its costs are borne by firms and workers in specific industries most often producing manufactured products such as shoes, color television sets, autos, and apparel. Workers in these industries obviously do not view imports from the perspective of the whole economy, but are concerned about the fate of their own jobs, health benefits, pensions and communities. Given the increased capability of many developing countries to produce and sell these items more cheaply, the problem is not going to disappear.

As long as it expands, the U.S. economy can absorb many of the affected workers but not without costs to individuals and communities. In addition, most governments in developed countries provide some kind of special assistance to workers and firms to adjust to these import pressures. Under this approach, retraining of the unemployed and facilitating the transfer of resources to more productive areas of the economy are priority concerns. The idea that U.S. workers adversely affected by imports should receive preferential treatment compared to those affected by the ups and downs of the national economy is being questioned by the Reagan Administration.

Trade restrictions can be self-defeating in the long run.[29] Restrictions on imports reduce other countries' exports and hence the foreign exchange available to them for importing. Reduced imports mean that someone's exports eventually will decline. Arguably, in the long run jobs can be "saved" in import-competing industries only at the expense of jobs "lost" in export-competing industries.

POLITICAL FACTORS

Some analysts believe that there are even more fundamental challenges to liberal trade policies than the spread of conditional MFN and the adjustment problems associated with increased levels of imports. This view is that world trade operates most successfully when

[27] See, for example, Anne O. Krueger, Protectionist Pressure Imports and Employment in the United States. NBER Working Paper No. 461. March 1980.

[28] Walter S. Salant, The Effects of Imports on Domestic Employment: A Clarification of Concepts, Special Report of the National Commission for Manpower Policy. Special Report No. 18, January 1978, pp. 32–33.

[29] Given the increased importance of trade in most economies, trade restrictions are also potentially more harmful. In the United States, for example, exports now account for over 12 percent of GNP, double the 6 percent in 1970. The potential disruption that trade restrictions might have on domestic production and employment is, thus, much greater.

one country provides strong world leadership, usually through its military and commercial dominance. As political scientist Susan Strange has stated:

> The liberalism of the 1950's and 1960's was not the norm of trade diplomacy in the world political economy, but rather a temporary aberation resulting from American military and commercial superiority. The strong trader was the free trade and nuclear and financial power gave the right to insist on trade liberalization.[30]

Although this interpretation ignores the fact that some European countries have had long histories of liberal trade policy, it does make a simple and important point: that over the past decades the world has greatly changed with military and economic power more evenly distributed today. This shift may have important consequences for the world trading system.

As Europe and Japan recovered from the effects of World War II, they became strong competitors (and customers), and U.S. trade policy became increasingly concerned with the specific commercial interests of U.S. exporters and importers. The view that U.S. policy in the past often accepted discrimination against U.S. exports and uneven trade rules and agreements primarily out of concern for political objectives gained wide acceptance in the 1970's and was articulated in the Trade Act of 1974, the Trade Agreements Act of 1979 and Reorganization Plan No. 3 of 1979.[31]

Concern recently has been voiced that the gradual shift in emphasis from overriding political objectives and sensitivities, represented by the State Department's leading role in trade policy over a number of years, to more strictly commercial objectives may have gone too far. At issue is whether some of the current trends in policies are best suited or appropriate for achieving the long-run interests of the United States. For example, criticism of recent amendments to the antidumping and countervailing duty laws, adopted as part of the Trade Agreements Act of 1979, is based on the shift toward excessively legalistic and administrative proceedings.[32] It is argued that the current procedures insulate decisionmakers from considering important "facts" such as the potential effect of the decision on political relations with foreign governments. The 1980 antidumping petition filed by the U.S. Steel Corporation covering over a billion dollars of steel imports from seven of our European allies exemplifies the problems that inflexible administrative proceedings can create. Unable legally to negotiate a resolution of the suit through bilateral consultations with the EC, the Carter Administration was forced to reinstitute the trigger price mechanism to persuade U.S. Steel to drop the petition in order to avoid damage to our relations with these countries. The problem is that there is very little scope in these provisions for considering much beyond the interest of the particular U.S. producers who have petitioned for relief.

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[30] Susan Strange, "The Management of Surplus Capacity: Or How Does Theory Stand Up to Protectionism 1970's Style?", International Organization, vol. 33, No. 3, Summer 1979, p. 305.

[31] The Trade Act of 1974, for example, provided specific economic objectives for U.S. participation in the Tokyo Round. It also provided a new provision (section 301) which gives the President authority to unilaterally retaliate against unfair foreign trade practices.

[32] Peter D. Ehrenhaft, "What the Antidumping and Countervailing Duty Provisions of the Trade Agreements Act (Can) (Will) (Should) Mean for U.S. Trade Policy," Law and Policy in International Business, vol. 11, 1979.

III. U.S. Trade Policy in the 1980's

Along with the challenges to the world trading system, U.S. trade policy in the 1980's must confront a number of difficult issues. Increased competition in domestic and foreign markets and efforts to apply and enforce the new trading rules will raise major problems for U.S. trade policy.

Domestically, efforts to strengthen the domestic economy, enhance the U.S. export position and improve import adjustment policies will be priority concerns. Internationally, negotiations will continue on key issues that were not adequately resolved or which were never addressed in the Tokyo Round. Attempts to negotiate new multilateral rules or to improve existing rules regulating barriers to trade will be given priority. Specifically, issues relating to the implementation of the MTN agreements, the negotiation of a safeguards code, the reduction of barriers to trade in services and investment, policy on trade with developing countries, and trade with non-market economies are all on the trade agenda. Resolution of these issues will affect the international position of the United States during the 1980's.

Domestic Economy

The Reagan Administration's recent "Statement of U.S. Trade Policy," the so-called White Paper, emphasizes the importance of restoring noninflationary growth in order to improve the U.S. trade position in domestic and foreign markets.[33] The reason why a healthy economy is critical for improving U.S. trade performance is clear. Greater economic growth will raise productivity, create new jobs and facilitates the transfer of workers and capital in declining industries to growing and more profitable sectors of the economy. Lower levels of inflation will help make U.S. products more competitive abroad. The Administration's White Paper emphasizes that a trade policy which maintains open markets at home and abroad contributes to the twin goals of lower inflation and increased growth.

Although it is uncertain whether the Administration's economic recovery program will achieve lower inflation and higher growth, the international effects of the current domestic economic policy seem clearer. The policy will probably result in a larger trade deficit. Partially as a result of a tight monetary policy and a less stringent fiscal policy (along with large trade deficits and political uncertainties abroad), the dollar has strengthened dramatically in foreign exchange markets. A stronger dollar can help in the fight against inflation, enhance U.S. international economic leadership, and contribute to international monetary stability. However, it is likely that today's strong dollar will contribute to a deterioration in the competitive position of U.S. exports over the next two years. This in turn could lead to current account deficits in 1982 and 1983, and perhaps to a return to the 1977–78 situation of a declining dollar, accompanied by international monetary instability.[34] In addition, the tight monetary policy and high interest

[33] The Reagan administration's nine-page "Statement on U.S. Trade Policy" was released on July 8, 1981, before a joint oversight hearing of the Senate Committee on Finance and Senate Committee on Banking, Housing, and Urban Affairs. Copies may be obtained from the Office of the United States Trade Representatives.

[34] This view is held by C. Fred Bergsten, former Treasury Assistant Secretary in The Carter Administration. The Reagan Administration hopes that the dollar can remain stable, even in the event of large current deficits, if non-inflationary economic growth is restored. See Washington Post. IMF Report Shows an Inward-Looking Trade World [by] Hobart Rowen. Aug. 3, 1981 [Washington Business], p. 3.

rates in the United States have forced European countries to tighten their monetary policies which in some cases run opposite to domestic economic policy objectives. Much of the discussion at the recent economic summit in Ottawa, in fact, focused on these problems which are created by the growing interdependence of the world's economies.

Import Adjustment Policies

Import issues are highly contentious. Jobs and company profits are at stake. Given increased competition in world markets, and high levels of unemployment in all the industrial countries, pressures placed on governments to provide relief to industries, firms, and workers injured by import competition can be expected to increase.

The Reagan Administration, according to its White Paper, will resist these pressures to provide such relief and instead rely substantially on market forces. An administration spokesman elaborated further on the newly enunciated trade adjustment policy in a recent congressional hearing:[35]

> The emphasis in trade adjustment policies should be just that: adjustment, not preservation of an uncompetitive industrial structure. A healthy, dynamic economy is a flexible economy, where businessmen, consumers, and workers have a continuing opportunity to invest their capital, tailor their budgets and find employment in response to market forces unaffected by artificial government barriers or props. Thus, while there may be a role for government assistance to individual workers who have lost employment because of import dislocations, this assistance should be temporary, and oriented toward facilitating their search for new employment in other industries and, conceivably, in other locations. The general rule in trade adjustment situations should be to help individuals, not industries per se.

Implementation of a market-oriented trade adjustment philosophy will create challenges and controversy. Already upon the recommendation of the Administration, the trade adjustment assistance program for workers has been drastically curtailed and the inactive trade adjustment program for communities will be terminate in 1982. In support of the President's budget reductions, amendments to the trade adjustment assistance program for workers entailing much stricter certification standards are expected to result in an 80 to 85 percent cutback in the funding of the program, from $1.5 billion to $200 million. The trade adjustment assistance program for firms has been amended to conform to the stricter criteria of the worker program. The Reagan Administration has expressed its intention to keep funding for the program at the $50 million level.

The utilization of import restrictions to allow industries time to adjust to changed competitive circumstances will also be closely monitored. To date, the Reagan Administration has rejected a recommendation by the U.S. International Trade Commission to extend quotas on Taiwan's footwear exports, but it has urged the imposition of "voluntary" controls on the export of Japanese automobiles. Future industry adjustment problems that will test the Administration's free-market approach include proposals to impose import restrictions on tobacco and efforts to tighten the import restrictions on textile and apparel products through the implementation of the Multifiber Arrangement Regulating Trade in Textiles.

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[35] Testimony of Murray L. Weidenbaum, Chairman, President's Council of Economic Advisers before The Senate Banking and Finance Committees on July 9, 1981, p. 12.

Political support for the Administration's import adjustment approach likely will be affected by the enforcement of the domestic unfair trade statutes. Congressional sentiment supporting "free but fair" trade and reciprocity in U.S. trading relations stems, in part, from a longstanding view that the Executive Branch in the past has not rigorously enforced U.S. countervailing duty, anti-dumping and similar laws on unfair trade practices. The Reagan Administration has announced its intention to enforce strictly unfair trade laws as well as the steel trigger price mechanism.

Export Policies

U.S. export performance has shown signs of improvement over the past two years. Due substantially to the lagged effects of the depreciation of the dollar in 1977 and 1978, U.S. exports of manufactured products grew by 23 percent in 1980, increasing the U.S. world share by nearly a full percentage point to 18.3 percent.[36] The growth of U.S. exports of goods and services also was stronger in the 1970's (averaging 8.6 percent per year) than in the 1960's (6.3 percent.)[37] Despite this progress, it remains clear that there are numerous U.S. policies that still handicap U.S. exporters and prevent U.S. exports from increasing at an even faster rate.[38]

Government policies and regulations which hinder U.S. exporters through the creation of barriers or additional costs have been termed export "disincentives." Many businessmen maintain that some of these self-imposed barriers are more onerous than many foreign government imposed barriers. The extent to which export opportunities are lost because of disincentives is not easily quantifiable, but the removal or modification of U.S. export disincentives has emerged as a major concern of both the Administration and Congress.

Priority will be given to modification of three export disincentives—export control regulations, tax treatment of U.S. citizens working abroad, and the Foreign Corrupt Practices Act—in an effort to allow exporters more leeway to exploit commerical opportunities abroad. Other export disincentives such as anti-boycott provisions, human rights restrictions on economic and military assistance and export credits, the extraterritorial reach of U.S. antitrust laws and cargo preference requirements will likely also be given some attention in the near future.

The United States has employed export controls since 1940 in the interest of national security, foreign policy, and avoidance of critical shortages. Unlike other Government policies that are frequently labeled export disincentives, export controls are intended to prevent the export of certain goods and services. Restrictions on agricultural exports to the Soviet Union, the partial embargo on shipments to South Africa, and limitations of high technology sales to virtually all Communist countries are among the limitations imposed under the export control authority.

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[36] Department of Commerce, Business America, July 3, 1981, p. 6.
[37] Weidenbaum, op. cit., p. 4.
[38] Export Promotion, Export Disincentives, and U.S. Competitiveness. Report by the President Pursuant to Section 1110(a) and (b) of The Trade Agreements Act of 1979. Committee Print, Senate Committee on Banking, Housing, and Urban Affairs. Washington, D.C., September 1980.

Critics of the controls seldom contest the legitimate goals which the regulations attempt to achieve, but maintain that the regulations and procedures are arbitrary, time consuming, and unnecessarily restrictive. Government efforts to make the policies more predictable and consistent are being undertaken. In the area of national security controls, an attempt to develop a list of critical technologies so that sensitive exports can be identified and non-sensitive items exempted from specific licensing reviews has been underway for several years. A continuation of this effort can be expected. There is also strong concern in Congress about the differential impact of export controls, particularly that the agricultural sector of the economy not be asked to sacrifice more than any other sector of the U.S. economy.[39]

Beyond the export control statutes, and perhaps more significant in terms of lost export opportunities, are the treatment of taxation of foreign earned income and the Foreign Corrupt Practices Act. Under current law, U.S. citizens working overseas are provided limited tax relief. Despite the special deductions for extraordinary living expenses and for hardship posts, U.S. businessmen frequently complain about the high cost of employing U.S. citizens abroad. They maintain that Americans have been replaced with foreign nationals who may be paid less because their incomes are not taxed while they are resident or domiciled outside their own countries. Arguably, one consequence of replacing Americans in key positions with foreign nationals is that sales of foreign rather than U.S. goods and services are promoted.

More generous exclusions for income earned abroad are included in Public Law 97–34, the Economic Recovery Tax Act of 1981, which became law on August 13, 1981. The changes undoubtedly will lower the cost of maintaining American employees overseas, but the impact on U.S. exports is more problematical. One recent study maintained that a reduction in American employment overseas has resulted in a drop in real U.S. exports by about 5 percent.[40] The reliability and validity of the study's conclusions, however, have been challenged by a number of observers.[41]

The Foreign Corrupt Practices Act is another contested provision allegedly resulting in lost export opportunities. The Act, which makes it illegal for U.S. citizens to make payments to foreign government officials for the purpose of obtaining business, is often viewed as an imposition of U.S. ethics on unreceptive foreign states. It also imposes accounting and record keeping regulations on U.S. corporations. A number of U.S. corporations maintain that the Act has been responsible for a loss of foreign sales.

One proposed solution to the competitive disadvantage suffered by U.S. exporters is an international agreement on illicit payments. The need for such an agreement has been endorsed by former President Carter, who raised the issue at the Venice Economic Summit in 1980, and more recently by the Reagan Administration. Another proposed solution is enactment of legislation clarifying some of the ambiguities

[39] Legislation has been introduced in the 97th Congress requiring the President to impose controls on all exports, and not just agricultural exports, in cases such as the Soviet invasion of Afganistan.

[40] Chase Econometrics. Economic Impact of Changing Taxation of U.S. Workers Overseas. June 1980.

[41] For example, see Tax Notes. A Critique of the Chase Study of the Tax Treatment of U.S. Workers Overseas [by] Victor Thuronyi. June 30, 1980, pp. 979–984.

in the FCPA. Legislation which aims at accomplishing that goal has been introduced in both houses in the 97th Congress.

In addition to reducing export disincentives, efforts will be made to provide positive support for U.S. exports. The major U.S. Government programs designed specifically to promote exports are tax incentives, export credits, and informational and marketing programs. The principal tax incentive is the Domestic International Sales Corporation (DISC), which is designed to make exporting more profitable by, in effect, lowering the tax on corporate profits. Attracted by deferral of Federal income taxes on one-half of its income profits, DISC's established by major U.S. corporations have accounted in recent years for almost two-thirds of U.S. manufactured exports.

The DISC provision is controversial. Our trading partners question whether the DISC is an internationally accepted tax incentive scheme. The costs and benefits of DISC are also highly contentious. The Carter Administration maintained that DISC is an inefficient use of taxpayers money and recommended that it be either phased out or revised to a simpler and less costly form. The Reagan Administration, however, is attempting to redesign the DISC into a new incentive scheme which will provide the same level of incentive and will be compatible with the international rules of the GATT.

The Export-Import Bank (Eximbank) of the United States is the principal source of official credit provided to U.S. exporters to improve their ability to compete in international markets. Although the Reagan Administration originally intended to reduce the Eximbank's lending authority by about $1 billion as part of its budget cutting plan and free market philosophy, Congress, without opposition from the Administration, approved measures restoring substantial amounts of Eximbank funds. A large factor affecting support for increased Eximbank funding has been the lack of success in securing agreement among major trading countries, particularly France, to reduce the subsidy element in export credit financing. If international agreement cannot be reached on reducing export-subsidy competition, the Reagan Administration has indicated a willingness to meet the foreign competition through increased resources and more attractive credit terms. Moreover, legislation has passed the Senate and House Banking Committees to establish a $1 billion Competitive Export Fund to combat foreign export credit subsidies. The fund would be used in the event no international agreement limiting export credit competition is reached.

Less controversial than the tax and credit programs are a variety of Department of Agriculture, Commerce and Small Business Administration programs to promote exports through informational and marketing services. Perhaps one reason they are less controversial is that the program costs (all of which are under $100 million) are significantly less than the credit and tax programs. Many of the informational and marketing programs are also targeted to help small and medium size firms get involved in exporting. In the past a major criticism has been that the programs, particularly those administered by the Department of Commerce, have been poorly managed. The Reagan Administration has pledged to ensure that these export promotion programs are more effectively utilized.

Implementation of the MTN Agreements

Implementation of the MTN agreements is a more difficult task than was the case for previous multilateral agreements that focused on the reduction of tariffs. The reduction of tariffs can be a simple, automatic process, but the implementation of nontariff codes is far more complex.

The first task is to obtain widespread international acceptance of the codes. As mentioned previously, most of the industrialized trading countries have signed some or all of the agreements but the participation of developing countries has been disappointing. Efforts to obtain greater participation will continue. Without greater participation, strains will likely be placed on the world trading system. It is also necessary to establish procedures for carrying out national obligations under the codes and for settling disputes. The codes, which are formulated in terms of general principles, must be interpreted and applied to specific cases. Disagreements among governments that were papered over during the negotiations with ambiguous language will have to be resolved as specific cases are brought before GATT dispute-settlement panels.

Although most of the codes have been in place for over nineteen months, there has been no thorough examination of the progress and problems entailed in the implementation process. Only limited and anecdotal evidence points to specific problems that have been discovered in the codes themselves or in initial Government implementation actions.[42] Customs authorities in European countries reportedly still place arbitrary values and thus inflated duties on imports, which is contrary to the customs valuation code. Few comments on proposed foreign health and safety standards have been submitted by U.S. business and no formal complaints have been initiated under the product standards code. Despite major efforts to publicize bid opportunities under the Government procurement code, which prohibits discrimination between foreign and domestic suppliers in specified Government purchases, no major Government contracts so far have been won by foreign producers. Similarly, the subsidies/countervailing duty code, which provides a major new weapon against subsidized foreign products that compete with U.S. exports in third country markets, has not been utilized. This initial impression of limited and somewhat disappointing progress will be examined by Congressional trade committees with oversight jurisdiction over MTN implementation in the 97th Congress.

Safeguards Code

One of the biggest disappointments of the MTN was the failure to reach agreement on a Safeguards Code, which would provide a set of improved rules for countries taking "escape clause" actions to protect domestic industries from injurious import competition. The basic "escape clause" (Article XIX of GATT) permits unilateral withdrawal or modification of import concessions or other GATT obligations when they result in increased imports that cause or threaten serious injury to domestic producers. Article XIX provides for prior consultation and subsequent compensation.

[42] For such a review, see Journal of Commerce, "Tokyo Round Codes Lie Fallow" [by] Elizabeth V. Perkings, July 28, 1981, p. 4A.

Over the years, as discussed above, great uncertainty developed concerning the types of situations that warrant safeguard actions and, in turn, the types of protective or remedial measures that may legitimately be taken. Problems of this kind have proliferated as countries have disregarded the GATT safeguard procedures. Orderly marketing agreements (OMA's) and voluntary restraint agreements (VRA's) are examples of safeguard measures increasingly used outside the GATT rules.

The main disagreement in the safeguards negotiations is over the issue of "selectivity." The European Community insists that countries be allowed to apply import restrictions against selected exporting countries, rather than applying such measures on a non-discriminatory basis (i.e., to all suppliers of a commodity). The developing countries and Japan maintain that selective use of import restrictions is inconsistent with the most-favored-nation or non-discrimination provision of the GATT, and undermines much of the economic rationale and potitical support for a multilateral trading system. The United States basically opposes selectivity and has attempted to negotiate a code that would provide rules, standards, and international surveillance over the use of safeguard measures. The negotiation of a safeguards code will remain an important trade issue because without such a code orderly marketing and voluntary restraint agreements are likely to proliferate.

Trade In Services

The services sector of the U.S. economy has grown rapidly in the past thirty years. Services, which include such industries as accounting, banking, insurance, telecommunications, and transportation have now replaced the manufacturing sector as the dominant element of the U.S. economy. Currently, nearly half of GNP and close to 70 percent of all U.S. jobs are derived from services. While U.S. exports of services have nearly doubled in six years from $17 billion in 1974 to $31 billion in 1979, their growth has been hampered by foreign import restrictions and other discriminatory policies.[43]

As the world's leading trader of services, the United States has a strong interest in eliminating barriers to such trade. Various U.S. agencies and the Organization for Economic Co-operation and Development (OECD) have mounted initiatives to identify barriers in order to create a consensus in favor of a major multilateral negotiation.[44] The purpose of the negotiations would be the development of multilateral principles, rules and procedures for the liberalization of trade in services and for the resolution of international disputes in the field.

Any negotiations on services will be difficult. To begin with, no comprehensive data on services barriers exist. Some barriers to services interfere with overseas investment while others interfere with merchandise trade. For example, investors in overseas service enterprises often experience difficulty with remittance of profits, discriminatory taxes and inadequate protection of trade marks and copyrights. Traders have to contend with government-subsidized competition, com-

[43] Driscoll, David D. U.S. International Service Trade. Congressional Research Service, Library of Congress. Report No. 80–124 E, Aug. 21, 1980, 18 pages.

[44] Driscoll, David D. "Initiatives to Reduce Barriers to International Service Industries." Congressional Research Service, Library of Congress. Report No. 80–207 E, Dec. 2, 1980, 19 pages.

petition from nationalized industries, and discriminatory licensing regulations. Because so many of the barriers are intertwined with domestic regulations and policies, barriers will not be easily removed. A protracted process of building political support for bilateral and multilateral negotiations in services can be expected.

Investment Policies

The 1970's witnessed a rapid increase in U.S. foreign direct investment flows. Between 1970 and 1979, U.S. direct investments in foreign countries more than doubled from $75.5 billion to $192.6 billion. Foreign direct investments in the United States grew at an even faster rate, rising from $13.3 billion in 1970 to $52.3 billion in 1979. In aggregate terms, the importance of these flows is illustrated by the fact that in 1979 U.S. income from foreign direct investment exceeded foreign receipts from direct investments in the United States by $35.8 billion, providing a substantial offset to a merchandise trade deficit of $29.5 billion. In addition, earnings from foreign direct investments, as a percentage of total profits of U.S. corporations, have grown from 12 percent in 1970 to over 33 percent in 1980.

The traditional explicit U.S. policy toward investment has been one of neutrality, neither encouraging nor discouraging foreign investments. Both the rapid increase in foreign direct investments in the United States in the 1970's and the increasing incidence of foreign government policies that inhibit U.S. investments have become topics of increased controversy in recent years. Some members of Congress have been critical of the rise in foreign investments in the United States, some of which have been made in important U.S. industries. Legislation to restrict specific types of investments in the United States or to place conditions upon the investments has been proposed and introduced by some Members of Congress. In addition, the United Auto Workers' proposal to apply domestic content requirements to auto production and trade in the United States is expected to receive a Congressional review.

Unlike the current U.S. policy of neutrality toward foreign direct investment, some foreign policies tend to either artificially attract or inhibit foreign investments. Such policies include investment incentives by States and localities, which distort international investment by shifting the location of production facilities, and performance requirements, which require that a certain percentage of production be exported or produced with domestic labor and materials. Canada's national energy policy, which requires foreign firms to be at least 50 percent Canadian-owned by 1990, is the most highly publicized recent example of restrictive investment policies. U.S. trade policymakers thus face the task of initiating multilateral or bilateral negotiations to reduce or eliminate many of these policies that distort trade and investment and adversely affect U.S. commercial interests. If negotiations fail, the Reagan Administration likely will consider some form of retaliation against the most egregious restrictions.

Trade With Developing Countries

Developing countries are of growing importance to U.S. trading interests. As a whole, they constitute the fastest growing market for

an increasingly large share of total U.S. exports. During the 1970's, U.S. exports to developing countries grew at an annual average rate of 20 percent, compared to 15 percent for U.S. exports to developed countries. In 1980, developing countries accounted for over 35 percent of U.S. exports, a share exceeding the combined total of East and West Europe, the Soviet Union, China and Japan. This compares to a 30 percent share in 1970. The United States is even more heavily dependent on developing countries for imports. In 1980 imports from developing countries accounted for over 45 percent of total U.S. imports with particular heavy dependence on oil and raw material supplies. In addition, the United States has a large and growing stake in investment and private lending activities to developing countries.

Much of the attention of the Tokyo Round was devoted to defining special rules for developing country participation in the world trading system. The key document in this respect was the MTN Framework agreement, which established a legal basis for the differential treatment of developing countries (i.e., that they would have fewer obligations and receive preferential treatment in recognition of their developing status). The concept of graduation (i.e., where the preferential treatment would be phased out for countries that reach more advanced levels of development and where eventually greater obligations of the world trading system would be undertaken) was also established. The concept of differential treatment is embodied in the nontariff barrier codes negotiated in the Tokyo Round and also in the U.S. Generalized System of Preferences (GSP).

A major trade problem in the 1980's will arise from government attempts to apply these concepts to different countries at different levels of development. In applying the concepts to actual trade issues, subjective judgments concerning stages of development, the nature of developing country policies which restrict trade, and the importance of a particular industry or sector to a developing country's overall economy, will have to be made. Already, as previously discussed, such initial decisions by U.S. trade policymakers have caused friction with India on the subsidies/countervailing duty code.[45] During the next few years, more difficulties in applying a regime of differential treatment and graduation on a country-by-country basis can be expected.

The U.S. GSP provides preferential treatment for many agricultural and manufactured products of developing countries to enter the United States free of duty. The program provides for the removal of preferential treatment for particular products whenever exports from any beneficiary developing country reach competitive levels (as determined by a "competitive-need" formula provided for in U.S. law).

The program has been criticized both by eligible developing countries and by representatives of those industries that are affected by duty-free GSP imports.[46] The beneficiary developing countries are particularly dissatisfied with the exclusion of a number of products of great interest, such as textiles and footwear. They also believe that the competitive need formula is too restrictive. In contrast, U.S. labor and business interests maintain that both products and countries

[45] Journal of Commerce, "India Scores U.S. Finding On Fasteners," July 22, 1981, p. 3.
[46] See Congressional Budget Office, "Assisting the Developing Countries: Foreign Aid and Trade Policies of the United States," September 1980, pp. 65–86.

should be removed permanently from eligibility under certain circumstances. They point to the fact that five advanced developing countries have accounted for over one-half of GSP trade. The contention is that the permanent removal of both specific product and country eligibility is necessary in order that the poorest developing countries can take advantage of GSP. Legislative changes in the program will be considered in the 97th Congress.

Trade With Non-Market Economies

United States trade with non-market economies has grown rapidly in the past five years, increasing over six-fold since 1975.[47] The volume of trade, however, still accounts for a small portion of total U.S. trade, less than 3 percent in 1980. Nevertheless, commercial importance is attached to expanding trade with these countries because they do, together with the developing countries, represent a potential growth market for U.S. exports.

Special considerations, both political and economic, condition U.S. trade policy toward non-market economies. Economic, political and strategic considerations in the past have been of overriding importance. Various actions linking trade with the political behavior (both domestic and foreign policy) of these countries were taken during the 1970's. The Reagan Administration has announced a continuation of this policy in its East-West trade report:[48]

> United States trade policy towards the nonmarket economy countries must be viewed in the context of overall bilateral relations as well as in the context of international commitments. As such, this policy recognizes the inter-relationship among the economic, political and strategic factors shaping bilateral relations. This clearly implies that U.S. bilateral trade relations will vary from country to country. Not only will U.S. trade relations differ between nonmarket economy and market economy countries, but our trade relations with countries within these groups will also differ.

Thus, a variety of differential bilateral trading relationships can be expected to continue under the Reagan Administration.

In instances where bilateral political factors occasion a decision to expand commercial relations, various U.S. statutory or regulatory restrictions would be considered for removal.[49] The biggest handicap for most of these countries in increasing their imports from the United States is a shortage of foreign exchange. Thus, eligibility to receive Export-Import Bank and Commodity Credit Corporation financing would be critical for some of the countries which are not presently eligible. Numerous obstacles, other than those imposed by U.S. laws, resulting from the differences between market and non-market oriented economies might also have to be addressed by policymakers. Problems concerning the implementation of trade agreements and concessions, nontariff barriers, and the fuller integration of these countries into a world trading system characterized by market-ori-

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[47] The term "non-market" economy generally applies to Albania, Bulgaria, Cambodia, Cuba, Czechoslovakia, German Democratic Republic, Laos, North Korea, People's Republic of China, Poland, Romania, Union of Soviet Socialist Republic and Vietnam.

[48] East-West Trade Report. April 1981. Copies may be obtained from the Office of the United States Trade Representative.

[49] For an exhaustive examination of such restrictions, as related to East European countries, see Vladimir Pregelj, "Normalization of U.S. Relations With East Europe." In U.S. Congress, Joint Economic Committee, East European Economic Assessment—Part 2, July 10, 1981, pp. 667–684.

ented rules might all have to be addressed contingent upon an expansion of commercial relations.

IV. Conclusion

The world trading system and U.S. trade policy face serious challenges in the 1980's. Although the major trading countries have made only moderate use of safeguard actions in recent years, many of the trade restrictions have been implemented on a selective and discriminatory basis. Critics of such implementation assert that it undermines the economic efficiency, political trust and the rules of GATT and could encourage future protectionist actions. More immediate challenges are government actions to regulate trade in the textile and steel sectors more tightly. These trade decisions pose difficult problems because they involve, on the one hand, jobs and profits of particular workers and firms, and on the other hand, an overall economic concern to fight inflation, to raise real wages nationally and to reduce unemployment. The aspirations of developing countries for greater economic growth depend substantially on finding lasting solutions to these problems.

Difficult domestic and international economic issues present opportunities for improvement in the U.S. trade position and the rules of the world trading system. Domestically, the Reagan Administration's economic recovery program, import adjustment and export expansion policies are all intended to enhance U.S. trade competitiveness. Difficulties caused by the current strength of the dollar and some political opposition to a free market import adjustment policy can be expected. The outcome of negotiations to limit international credit competition will substantially determine the extent to which the United States increases its financial support to U.S. exporters.

Internationally, in the near future an assessment will be made on the extent to which the MTN agreements have provided for a more open world trading system. The outcome of negotiations on a safeguards code and barriers to trade in services and foreign direct investment will also influence the economic growth of the United States and the openness of the world trading system. U.S. trade relations with developing countries and non-market economies not only are becoming more important, but they pose difficult political and economic issues. As in the past, overall U.S. trade policy and the world trading system will be also influenced by foreign policies and developments, issues which are beyond the scope of this review.

U.S. INTERNATIONAL COMPETITIVENESS

By Robert Z. Lawrence*

I. Introduction

In the 1970's, the United States recorded its first trade deficit in the twentieth century. Many have pointed to the deficits as indicating this economy's lack of competitiveness and have called for measures to bring the trade balance back into surplus.

The talk about the United States competitive position suggests the analogy of an athletic competition. Just as the prowess of a sprinter will depend upon a host of factors such as long legs, adequate diet, and intensive training, so international trade results from the interplay of a wide variety of forces such as rates of productivity growth, wage rates, savings rates, capital formation, and technical change. No single indicator will serve as a reliable predictor of performance. Lengthening a sprinter's legs without changing the rest of his torso may make him wobby, increasing his diet without more exercise may make him fat, while lots of exercise without more food may simply make him weak. Even combining these factors to make him faster will be of little help in a race where his opponents start twenty yards down the track.

Higher rates of productivity growth, lower prices and costs, increased investment, or more research and development spending will not necessarily increase the trade balance. An increase in productivity could be reflected in higher wages and profits, leaving the international price competitiveness of U.S. goods unaffected. Lower prices for U.S. goods could result in a decline in the trade balance if the demand for these goods is not responsive to price. Investment that is not accompanied by higher savings could lead to larger current account deficits rather than smaller ones. Research and development could lead to products which are manufactured more cheaply abroad. And at any time, the effects of all of these changes could be offset by a movement in the exchange rate or a major business cycle fluctuation at home or abroad.

But the sports analogy could also be misleading. The fastest runner wins, but bigger trade balances are not necessarily better. Policy should not aim at a particular numerical value for the trade balance. More crucial are a set of sustainable international trade and capital flows that are compatible with domestic goals relating to growth, employment, inflation and the distribution of income. This could mean trade deficits or surpluses. Just as there are times when a household appropriately has expenditures exceeding its income, such as studenthood, retirement, or a sudden emergency, so there are times when an economy appropriately runs current account deficits. For example, a developing economy in which domestic savings are too meager to meet

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the available investment opportunities appropriately borrows from the rest of the world absorbing resources through its current account deficit. And a deficit (or surplus) which is due simply to business cycle fluctuations in one country need not indicate that fundamental adjustment is required.

The discussion above illustrates the pitfalls of the conventional wisdom which ascribes the trade deficit to a particular feature of the U.S. economy as if the causal connection between that variable and the deficit were self-evident. It is similarly inappropriate to point to the occurrence of a trade deficit per se as necessarily indicating that adjustment is called for. There is no substitute for a detailed empirical analysis of trade behavior. In this paper, I examine what we know and need to know about the nature and sustainability of past trends and about future prospects for U.S. international trade in goods and services.

II. THE U.S. CURRENT ACCOUNT

A. Composition

The current account, which forms the focus of this study, is the difference between the value of U.S. receipts from exports of goods, services, and remittances from foreigners, and U.S. expenditures on imports of goods, services, and remittances to foreigners. The components of the current account are recorded in Table 1. On the export side, the major components of merchandise trade in 1980 were agricultural ex-

TABLE 1.—THE U.S. CURRENT ACCOUNT, 1980

[In billions of dollars]

Current account category	Exports	Imports	Balance
A. Total goods and services	345	334	11
1. Merchandise trade (excluding military)	224	249	−25
Foods, feeds, and beverages	36	18	18
Industrial supplies and materials	72	135	−63
Fuels and lubricants	9	84	−75
Capital goods, excludes automotive	74	30	44
Automotive vehicles, parts and engines	17	27	−10
Consumer goods	17	34	−18
All other	8	5	3
2. Receipts (payments) of income on U.S. (foreign) assets abroad (in) the United States)	76	43	33
Direct investment	37	9	28
Interest, dividends, and earnings of unincorporated affiliates	20	3	17
Reinvested earnings of incorporated affiliates	17	6	11
Other private payments (receipts)	37	21	15
U.S. Government payments (receipts)	3	13	−10
3. Other services	45	41	3
Military	8	11	−3
Travel	10	10	----
B. Unilateral transfers (excluding military)	----	7	−7
C. Total current account (A+B) (excluding U.S. military grants of goods and services)	345	341	4
Merchandise trade by area:			
Industrial countries	137	127	9
Canada	41	42	−1
Japan	21	31	−10
OPEC	17	56	−38
Other countries	66	63	2

Note: Totals may not add up due to rounding.

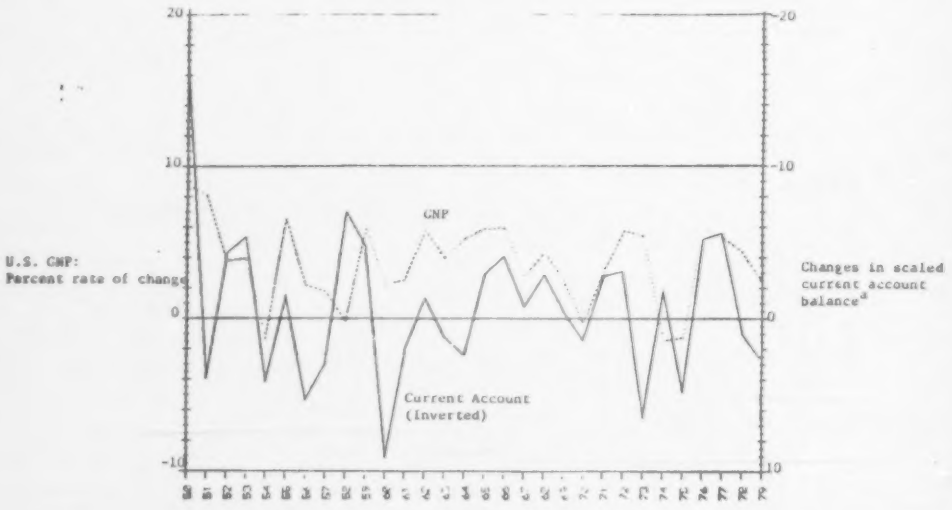
Source: Survey of Current Business, Department of Commerce, BEA, June 1981.

ports (16 percent) and manufactured goods (80 percent)—almost half of which were capital goods. On the import side, petroleum and products amounted to about a third of total merchandise imports, while manufactured goods were about fifty percent (mainly consumer goods and automotive products). In the services account, U.S. receipts of income from foreign investment are the most important credit item. The U.S. trade network is truly global with Canada accounting for about a fifth of the total value of merchandise imports and exports, other developed countries about thirty-eight percent, non-OPEC developing countries about a quarter, and OPEC about fifteen percent.

B. Trends

The volatile short-run changes in the United States current account result from business fluctuations and unique events such as wars, embargoes and crop failures. Such changes contrast sharply with the strong and persistent long-run trends which reflect the evolution of the United States into a mature creditor nation with a declining balance on merchandise trade and growing surplus from investment income. Compare the annual changes in the current account in Chart 1 (scaled as a percentage of the total value of trade) with the five-year averages of the current account's major components in Chart 2 and Table 2. There is no apparent trend in the annual short-run changes while, on the other hand, the long-run averages have remarkably continuous trends.[1] Had a naive forecaster simply extrapolated from the early developments in the component averages, he would have been qualitatively correct about their behavior throughout most of the period.

CHART 1.—Short-run current account changes are volatile and are correlated with GNP



NOTE.—(a) Changes in the ratio of the current account balance to sum of exports and imports of goods and services.

[1] Of course the more recent numbers have larger absolute values simply as a result of inflation.

TABLE 2.—COMPONENT BALANCES OF THE U.S. CURRENT ACCOUNT

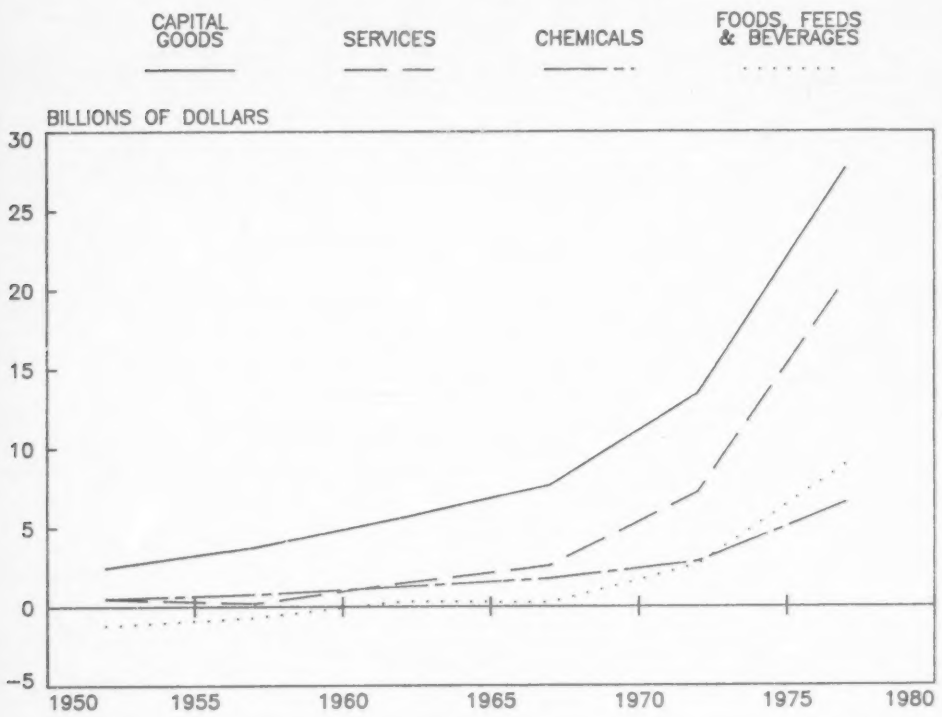
[In billions of dollars]

Period	Merchandise trade	Services	Transfers[1]	Current account
1950–54	2.2	0.5	−3.0	−0.3
1955–59	3.7	.2	−2.4	1.5
1960–64	5.4	1.5	2.6	4.3
1965–69	2.8	2.6	−5.1	2.4
1970–74	2.1	7.2	−4.4	.7
1975–79	−19.6	22.4	−5.1	−2.3

[1] Remittances, pensions, and other unilateral transfers.

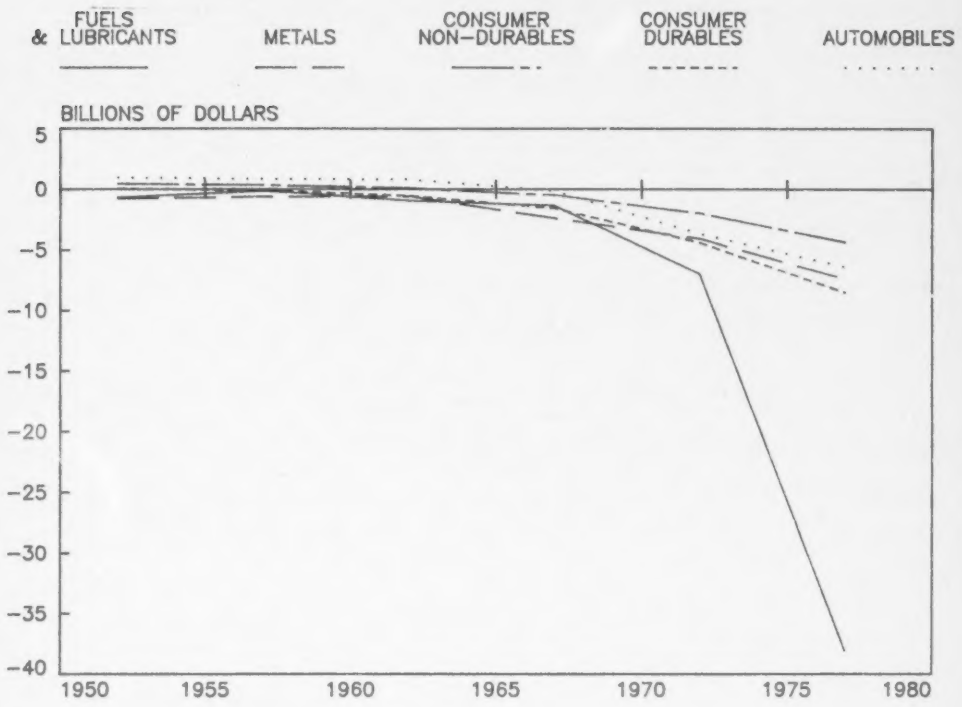
Source: Economic Report of the President and Department of Commerce Releases.

CHART 2a.—Increasing Balances of U.S. Trade (1950–79)



NOTE.—Data plotted represent 5-year averages.

CHART 2d.—Decreasing Balances of U.S. Trade (1950–79)



NOTE.—Data plotted represent 5-year averages.

1. AGRICULTURAL, FUELS, AND SERVICES

The trends in agriculture, fuels and services can be dealt with briefly. Despite widespread protectionism in agriculture, the U.S. has been able to increase its agricultural exports (mainly grains and oilseeds) as rapidly as other exports. On the other hand, U.S. agricultural imports are particularly concentrated in tropical products such as coffee and cocoa, the demand for which has not kept pace with the rise in income.

In the 1950's, the United States had been a net exporter of fuels, mainly coal, but by 1970, it had a fuels deficit of about two billion dollars. In the 1970's, U.S. oil imports had become the major marginal source of energy, required to make good the shortfall between the growing demand for petroleum and declining domestic supplies. This

transition—from self-sufficiency to a dependence on foreign oil for about half of total oil supplies—has coincided with two dramatic increases in the world price of oil orchestrated by the OPEC cartel in 1973 and 1979. Thus the value of petroleum and products imports has grown from $6.5 billion in 1972 to $78.9 billion in 1980.

The reaction of the U.S. economy to the second major oil price increase has been markedly different from the reaction to the first. Even though the decline in overall energy consumption from 1978 to 1980 was about half of that recorded from 1973 to 1975, the fall-off in oil consumption almost doubled. Recent experience has been marked by the substitution of alternative energy sources for oil and an increase in domestic energy supplies.

In the aftermath of the first OPEC price increase, the major source of energy conservation was the temporary suppression of demand that resulted from the 1974/75 recession. The industrial sector accounted for most of the decline in energy consumption. In contrast, the second price shock appears to have induced a more fundamental change in energy consumption patterns.

This time conservation has been centered in the transportation, residential and commercial sectors of the economy. Americans are now driving less, buying smaller cars, insulating their homes, and conserving on heating fuel.

The increase in domestic energy production over the past two years is the second major difference between 1978/80 and 1973/75. Coal production has been the major source of the growth in domestic energy supplies. With the movement toward decontrol of domestic gas prices and the rise of U.S. domestic oil prices to world market levels, the incentives for domestic production have improved dramatically. Exploration activity is on the rise, and new oil wells are being sunk in unprecedented numbers. And while thus far domestic oil and gas production have not increased, at least the decline in domestic production appears to have been arrested.

The response of the U.S. economy to the second OPEC price hike suggests that, barring a further major increase in world oil prices, the balance of trade in fuels and lubricants should not worsen the U.S. trade position in the next few years.

The services account reflects the role of the United States as a provider of arms, technology, savings, managerial skills, and private and official international liquidity to the rest of the world. The growing surplus in investment income results primarily from the U.S. net direct foreign investment position. Although foreign direct investment in the United States has grown rapidly in recent years, annual flows into the United States remain much smaller than the corresponding flow of U.S. direct investment abroad. The growth in the U.S. surplus from direct investment is likely to be sustained. It would take massive net capital inflows to the U.S. to raise the earnings potential of foreign direct investment assets in the United States ($6.9 billion in 1980) to that of U.S. direct investments abroad ($37 billion in 1980).

The empirical studies of U.S. trade either use an aggregative approach to explain the total volume of exports or a micro-economic approach to explain the commodity composition of exports and imports. In the next section I discuss the use of the aggregative approach in explaining U.S. manufactured trade, while in the subsequent sec-

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tion some of the findings of the micro-economic approach are described.

2. MANUFACTURED GOODS

Based on consumption theory, in which the demand for a commodity depends upon income and its relative price, the aggregative approach to trade analysis assumes that the volume of U.S. exports and imports depends (1) upon their price relative to those of substitutes, and (2) income of the United States (in the case of imports) or the "rest-of-the-world" (in the case of exports).[2] Sometimes, an additional cyclical variable is introduced to capture non-price rationing effects such as changes in delivery times and the influence of cyclical changes in the composition of demand.

I have used the aggregate approach to estimate a pair of equations for manufactured goods trade. These equations, reported in Table 3, provide a somber message. Other things being equal, similar rates of growth in the United States and the rest of the world will mean a declining U.S. balance in manufactured goods trade.

TABLE 3.—ANNUAL EQUATIONS FOR U.S. MANUFACTURED GOODS TRADE

[Variables in logarithms, t-statistics in parenthesis]

	Business cycle		Long-run output		Relative prices			
Constant	Q/Q^{*us}	Q/Q^{*row}	Q^{*us}	Q^{*row}	RPX	RPM	Standard error	Durbin-Watson
X (1962–77)	−9.4	1.24		1.30	Σ^{3} −1.68		0.03	2.0
	(5.4)	(3.5)		(33.1)	(4.9)			
M (1963–77)	−15.5	2.0	3.1			Σ^{3} −1.4	.051	2.1
	(3.2)	(2.8)	(16.8)			(2.4)		

Sources: X is the volume of exports of manufactured goods (standard international trade classifications 5–8) from Department of Commerce data. Q^{us} is GNP for the United States measured in 1972 dollars, from Comets Databank; Q^{*us} is Perry's annual estimates of potential GNP (George L. Perry, "Potential Output and Productivity," BPEA, 1:1977, pp. 11–47). Q^{*row} is actual manufacturing output in six major industrial countries (ROW) weighted by their 1970 shares in world manufactured goods trade; Q^{*row} is derived by similarly weighting the Artus estimates of the potential manufactured goods output of these countries. RPX is the ratio of unit values of U.S. exports of manufactured goods (from the Department of Commerce) to the United Nations unit value index for exports of manufactured goods (from various issues of United Nations, "Monthly Bulletin of Statistics"). M is the volume of manufactured goods imports adjusted to exclude automobile imports from Canada. Prior to 1968 it is formed from quantity indexes of imports of semifinished and finished manufactured goods. The numerator of RPM is the import-unit-value index for manufactured goods (standard international trade classifications 5–8). The 1962–67 values were estimated using coefficients from a 1962–77 regression of the import-unit-value index on finished and semifinished manufactured goods. The denominator is the U.S. manufactured goods wholesale price index with refined petroleum products removed. Both are from the Department of Commerce. RPM is multiplied by a tariff variable, which reflects the Kennedy round reductions and 1971 import levy (obtained from Peter Hooper of the Federal Reserve System). The prices are estimated as 3-year unconstrained distributed lags.

The equations indicate that for each one percent increase in United States output, U.S. manufactured goods imports will increase by 3.1 percent. On the other hand, for each one percent increase in output in the rest of the world, U.S. manufactured exports will increase by only 1.3 percent. Given the actual growth rates of potential output in the United States (of 3.7 percent) and potential output or "the-rest-of-the-world" (of 6.0 percent) for the period 1960–77, these equations imply annual growth rates of 11.5 percent for the volume of manufactured goods imports but only 7.8 percent for manufactured goods exports. If exports and imports were initially equal in value, to prevent a decline in the balance either U.S. growth would have to be one-third of

[2] The seminal study in this area is that of Houthakker and Magee. They found, using data from 1951–66, an income elasticity on U.S. imports of 1.5 but an income elasticity on U.S. exports of only 1.0.

that in the rest of the world or the relative price of U.S. goods would have to continuously decline. An extrapolation with reasonable U.S. and foreign growth paths into the 1980's, implies a strong erosion of the U.S. manufactured goods trade balance in the absence of improvements in relative U.S. prices.[3]

C. Pitfalls of the Aggregative Approach

Although trade flows in almost all of our econometric models are explained in this way, there are reasons not to place much confidence in these forecasts. The purely demand-style orientation of these equations and the fact that their coefficients have not remained stable over time [4] caution against placing too much faith in their use for long run projections.

1. THE OMISSION OF THE SUPPLY-SIDE

To justify the neglect of the supply-side, these equations require the assumptions that (1) foreign and domestic goods are imperfect substitutes and that (2) any quantity can be supplied at home or abroad without an increase in cost (infinite supply elasticities). But domestically produced commodities are likely to be close substitutes for imports of many producer goods (such as chemicals and metals) and consumer goods (such as clothing and shoes). In these cases, the coefficient of the income term in the equation would actually be capturing the difference between home demand and supply rather than the effects of home demand alone.[5] U.S. imports of steel may rise either because U.S. income has increased or because U.S. steel capacity has declined, but the conventional aggregate equations fail to distinguish between these effects. For standardized products, supply schedules at home and abroad should both be taken into account. If the foreign supply curve for steel shifts downwards over time, foreigners will increase their share of the domestic market at any given price. The conventional import specification which fails to include costs in the equation may well ascribe this foreign supply-side shift to the income variable in the equation.[6]

The interpretation of these equations as demand functions leads to the inference that the demand for the kinds of goods the U.S. imports [7] grows rapidly with incomes while the demand for goods similar to U.S. exports does not. Yet world trade in the types of goods the U.S. exports (typically high technology items and capital equipment) has actually grown much more rapidly than foreign incomes, and total U.S. consumption of the types of goods the U.S. imports (typically consumer goods and industrial supplies) has not grown substantially faster than U.S. GNP.

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[3] For a more complete exercise along these lines see Lawrence (1980). From 1973 to 1978, annual average growth rates in industrial production in the United States, OECD-Europe and Japan were 2.3, 1.0 and 1.3 respectively.

[4] See Hooper (1978) and Stern, et al. (1978).

[5] If $M(Y)=D(Y)-S(Y)$, where M is the quantity of imports demanded, D is the home demand for importables, and S is the home supply, this implies that $e_{my}=(D/M)e_{dy}-(S/M)e_{sy}$, where e_{my} is the import income elasticity; e_{dy}, the income elasticity of demand; and e_{sy}, the income elasticity of supply. For a discussion of this distinction and for the derivation of the equation for the import-income elasticity see Stephen P. Magee (1975), pp. 188–92.

[6] Goldstein and Kahn (1979) are an exception.

[7] Bela Balassa (1978).

The neglect of the supply side could lead to erroneous inferences. As the experiences of Japan and Germany illustrate (and the pure theory of international trade reminds us), growth that is biased toward an expansion of exportables could lead to a trade surplus rather than a deficit.[8] Only by explaining the sectoral bias of supply growth (together with the growth in demand) can one adequately model the effects of growth on the trade balance.

2. OTHER NEGLECTED FACTORS

There are many dynamic processes that are important to trade performance which the aggregative approach also fails to capture. In theory, given preferences and information, only incomes and relative prices determine demand. But when a foreign producer penetrates a new market, he is likely to invest substantial resources in familiarizing the market with his product. It will take time to establish a service capability, acquire a reputation, and pry customers loose from their old familiar habits. These effects would not be reflected in the price but they will shift the demand curve. It is reasonable to suspect the penetration pattern will follow the S-shaped curve that characterizes most adoption processes. The likely phases are a struggle to establish a foothold, a period of rapid growth, and a tapering off toward a long run share. Unless the econometric model allows for this, its estimates will be poor.

Strong trends are likely to be present in the variables omitted from these aggregate equations. Future work should include factors such as the growth in foreign capacity to supply U.S. tradeable goods, the decline in similar U.S. capacity, the market penetration by foreign producers, the influence of governmental foreign trade programs and other political influences on trade, changes in nontariff barriers to trade, the growth in recognition and reputation of foreign products, and changes in transportation cost. The current estimation procedure probably attributes the influence of these variables to the income variable which also has a strong upward trend. Since trends normally change quite sluggishly, these equations are quite useful in explaining short-run trade movements in which demand and relative prices are the most important sources of volatility. But the failure of these models to separately identify the effects of these variables is a severe deficiency in their use for long-run forecasting and policy purposes—particularly in a post-OPEC era in which so many trends appear to have changed.

3. PRICE MOVEMENTS AND PRODUCTIVITY

The secular performance of U.S. manufactured goods in international trade is often ascribed to the slower growth in U.S. labor productivity in manufacturing. From 1950 to 1973, for example, output per manhour increased at an average annual rate of 2.7 percent in the United States and 5.7 percent in other major industrial countries.[9]

[8] See, for example, the analysis in Johnson (1962), pp. 75–103 for a more complete analysis of the effects of growth on trade.

[9] Derived from Department of Labor Data. The "other industrial countries" aggregate is weighted by their 1970 shares in world manufactured goods trade.

(See Table 4.) In 1973–78 U.S. productivity rose only 1.7 percent annually as compared with 3.1 for the other countries. Assuming, however, that raw material costs increase by similar amounts, relative prices will depend not only upon relative productivity changes but also upon relative wages, relative profit margins and exchange rates. Faster foreign productivity growth has been more than offset by the growth in foreign compensation. In U.S. dollars, unit labor costs in foreign manufacturing sectors have actually risen more rapidly than those in the United States (See Table 5). From 1960 to 1970, for example, measured in U.S. dollars, U.S. manufacturing unit labor costs (corrected for cyclical changes in productivity) fell about seven percent relative to those abroad. But despite this reduction, U.S. price competitiveness was eroded—relative U.S. export unit values for manufactured goods actually increased by 5.3 percent. How can we explain the deterioration in U.S. price competitiveness despite the superior performance of U.S. manufacturing costs?

TABLE 4.—INTERNATIONAL GROWTH RATES OF OUTPUT PER HOUR IN MANUFACTURING[1]

	1950–73 (1)	1973–78 (2)	Slowdown (1–2)
United States	2.7	1.7	1.0
Canada	4.2	2.5	1.7
Japan	9.7	3.5	6.2
Denmark	5.2	4.7	.5
France	5.3	4.8	.5
Germany	5.8	5.1	.7
Italy	6.6	2.6	4.0
Sweden	5.3	1.5	3.8
United Kingdom	3.1	.2	2.9
Average (excluding United States)	5.7	3.1	2.6

[1] U.S. productivity in manufacturing is the slowest of any industrial nation.

Source: U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, "Output per Hour, Hourly Compensation, and Unit Labor Costs in Manufacturing, Eleven Countries, 1950–78" (July 10, 1979).

TABLE 5.—UNIT LABOR COSTS IN MANUFACTURING FOR MAJOR EXPORTING COUNTRIES[1]

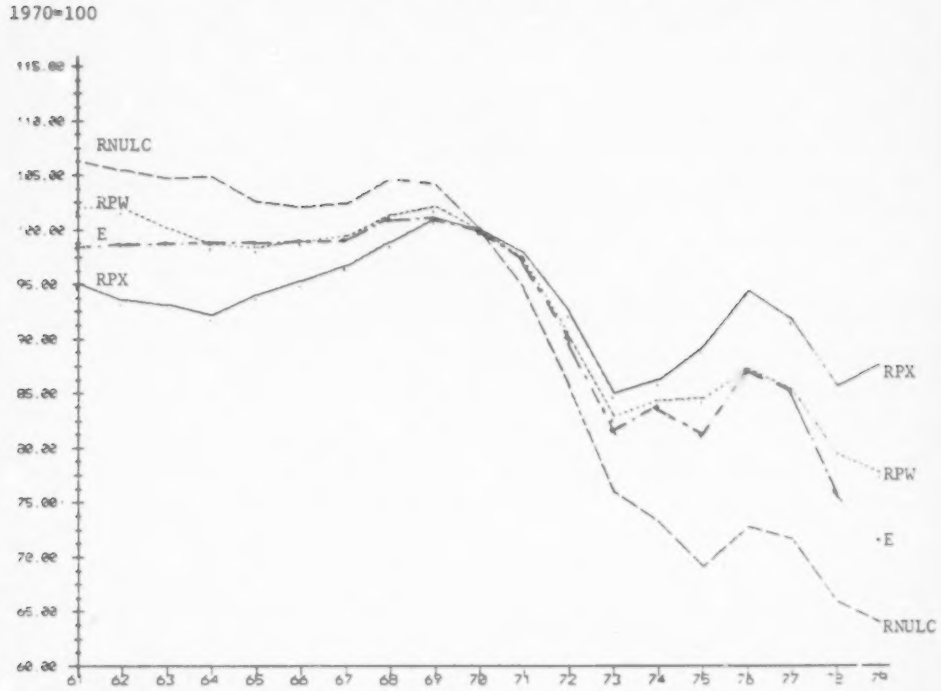
[In U.S. dollars]

Year average	Canada	Japan	France	Germany	Italy	Sweden	Netherlands	United Kingdom	United States
1950–54	91	87	87	65	72	63	54	64	77
1955–59	103	87	89	70	75	76	63	81	90
1960–64	96	90	90	88	87	87	77	91	96
1965–69	98	103	99	99	99	98	98	96	100
1970	112	113	97	126	119	105	109	106	117
1971	116	131	103	143	136	116	121	118	118
1972	122	160	118	164	152	133	139	127	118
1973	127	195	146	212	173	149	174	133	123
1974	148	237	157	236	183	165	198	160	143
1975	167	285	203	270	245	217	248	200	152
1976	187	285	191	258	213	241	240	185	158
1977	184	327	202	293	234	259	272	200	168

[1] U.S. wages have risen slowly so that unit labor costs have increased the least.

Source: U.S. Bureau of Labor Statistics.

CHART 3.—Cost and Price Comparisons for Manufacturing [1]



Key: RPX=ratio of export unit values of the United States to those of 13 other industrial countries.
RPW=ratio of manufactured goods wholesale prices of the United States to those of 13 other industrial countries.
E=Federal Reserve Board effective exchange rate, backcast to 1960.
RNULC=ratio of unit labor costs of the United States (corrected for cyclical changes in productivity) to those of 13 other industrial countries.

[1] U.S. relative export prices in manufacturing have declined much less than wholesale prices, the exchange rate, or relative unit labor costs.

SOURCE.—For a detailed description see International Monetary Fund International Statistics, vol. 32 (March 1979), p. 416. Data are from ibid, various issues.

In several foreign economies, productivity growth in the "export sector" has been considerably more rapid than productivity growth in the rest of manufacturing. Actual unit costs for export goods have risen less rapidly than those in other industries and export firms have therefore been able to lower their relative prices while at the same time expanding profitably. In fact, in the case of Japan it is possible to show that costs in export industries have risen much more slowly than in the rest of manufacturing simply by reweighting the industry costs by their export shares.[10]

Because foreign manufactured exports compete with U.S. products both in the United States and in third markets, changes in their prices relative to those of U.S. manufactured goods will be the major determinant of U.S. international price competitiveness. Since the price

[10] See Lawrence (1979) pp. 205–06 for a detailed analysis of the Japanese case. Further evidence is contained in Shinkai (1979).

of exports has declined relative to the price of total manufactured goods in some countries (while this has not been the case in the United States), for U.S. products to maintain their international price competitiveness, the average price of U.S. manufactured goods has had to rise less rapidly than the average in other countries.

The following equation summarizes this historic relationship for the 1962–78 period:

$$PX = 1.03 + 0.97\ PWP,$$
$$(2.6)\quad (8.4)$$

($R^2 = 0.81$; standard error = 1.5; Durbin-Watson = 2.0)
(t-statistics are in parenthesis)

where PX is the percentage change in the ratio of U.S. to foreign export unit values and PWP the corresponding change in the ratio of U.S. to foreign wholesale prices of manufactured goods. This equation implies that, if there had been no change in relative U.S. wholesale prices, relative U.S. export prices would have increased at an annual rate of 1.03 percentage points per year. For relative U.S. export prices to have remained constant, the relative prices of manufactured goods would have had to decline by 1.06 percentage points a year.

As long as the sectoral duality in foreign economies persists, the rule of thumb that U.S. relative manufactured goods prices should decline about a percentage point a year if relative export prices are to remain competitive may serve as a forecasting device. But we need to isolate the influence of factors such as economies of scale, technological imitation, embodied technical change and changes in factor endowments as causes of these disparities to be able to determine if they will persist.

4. EXCHANGE RATES AND PRICES

Exchange rate changes were an additional source of fluctuations in the 1970's. Rather than moving simply to offset differences in relative domestic inflation rates, the exchange rate has been instrumental in changing the relative price competitiveness of U.S. manufactured goods. Of the 27 percent decline in relative U.S. unit labor costs from 1970 to 1975, for example, about eleven percentage points were due to lower U.S. inflation rates while sixteen were due to the decline in the exchange rate.

5. THE ADJUSTMENT LAG TO EXCHANGE RATE CHANGES

The equations reported in Table 3 indicate that in the long run, a decline in the U.S. relative price of traded manufactured goods will improve the trade balance. But in the short run the response may be perverse.[11] Higher inflation abroad or a decline in the value of the dollar will raise U.S. import prices, but since the initial volume declines may be small, the trade balance in U.S. dollars may worsen in the first year after the change. However, within eighteen months to two years the response for both exports and importes is elastic—the volume effects outweight the price effects—and the trade balance improves.

[11] A more detailed discussion of the short-run response of U.S. manufactured goods trade to price change is found in Lawrence (1978).

Thus the dollar depreciations in 1971, 1973, and 1978 improved U.S. competitiveness and raised the current account in subsequent years; while the appreciation in 1975, on the other hand, contributed to the growth in the deficit in 1976 and 1977. Since, in addition to the current account, the exchange is influenced by other factors, most notably the relative level of U.S. and foreign interest rates the delayed effects of exchange rate changes have at times exacerbated the current account adjustment process. There is a danger, for example, that the strengthening of the dollar in 1980 and 1981 will have an adverse effect on the U.S. current account in 1982 and beyond.

6. THE TERMS OF TRADE

While effective in rectifying the trade balance, the relative improvement in U.S. manufacturing prices is not without its costs. When a current account deficit is not sustainable, it usually requires a reduction in real factor costs (i.e., wages and profits) and hence real incomes in order to correct it. This reduction is indicated by the decline in the ratio of export to import prices—the terms of trade—that a devaluation (or lower relative U.S. inflation rates) brings about.[12] As indicated in Table 6, the United States terms of trade declined quite substantially in the 1970's. While this decline is usually ascribed to higher oil prices, the table indicates that through 1977 the terms of trade in manufactured goods declined almost as much as they did in total trade. The table also indicates the association between the exchange rate and the manufactured goods terms of trade for most of the period.

TABLE 6.—TERMS OF TRADE

[1970=100]

Year	PXTOT / PMTOT	PXMAN / PMMAN	E
1960	95	99	99
1965	100	99	99
1970	100	100	100
1971	98	96	97
1972	94	91	90
1973	93	85	82
1974	79	74	84
1975	82	78	81
1976	82	82	87
1977	79	82	85
1978	78	78	76
1979	74	79	72
1980	67	80	72

Key:
PXTOT=U.S. export unit value index.
PMTOT=U.S. import unit value index.
PXMAN=U.S. manufactured goods export unit value.
PMMAN=U.S. manufactured goods import unit value.
E=Effective exchange rate (Federal Reserve Board).

Source: U.S. Department of Commerce.

7. CONCLUSIONS

The (demand-side) analysis of manufactured goods trade indicates that if the U.S. economy grows at rates similar to other countries the

[12] In theory, a devaluation could actually improve the terms of trade but, in practice, since manufactured goods have high supply elasticities, it usually worsens them.

manufactured goods balance will decline unless relative U.S. prices are lowered by a depreciation of the dollar (and) or a lower U.S. inflation rate. Moreover, some improvement in U.S. relative manufacturing costs will be required simply to maintain U.S. price competitiveness. The conventional Keynesian analysis leads to the prediction that slow foreign growth will lower the U.S. trade balance; however, supply-side analysis may well reverse this conclusion.

III. The Micro-Economic Approach

An examination of the multi-year averages of the major components of the current account in Chart 2 reveals the strength and persistence of the trends in the composition of U.S. trade. In almost every column the balance figures move continuously in one direction: Rising steadily for foods, feeds and beverages, chemicals, capital goods and services; and falling steadily for consumer goods, automotive products and, for the most part, industrial supplies and materials.

A. Factor Endowments

The Hecksher-Ohlin theory of trade predicts that an economy will specialize in the production of commodities which require the relatively intensive application of its more abundant factors of production. And the trade patterns of the United States corroborate the predictions of the theory: the growing surpluses are in commodities which require the relatively intensive application of land (food) and skilled and highly educated labor (chemicals and capital goods) while deficits stem from commodities which are made with unskilled labor (nondurable consumer goods) or which require resources that have been depleted (fuels).

It is more difficult to identify the contribution of physical capital in the formation of U.S. comparative advantages. As Branson has observed, "Physical capital plays a more neutral role combining relatively more with human capital in exports and unskilled labor (and natural resources) in imports. Good examples may be chemicals on the export side and consumer electronics (and steel) on the import side." [13]

Although the theory of relative factor endowments has provided some insights into the broad lines along which international specialization has proceeded, we remain unable to trace out the detailed effects of changes in relative factor endowments in the U.S. and the rest of the world on the composition of U.S. trade over time. We need to improve our time series data on relative factor endowments in different countries and then to link these to changes in trade performance.

B. Technology

Given the complex forces that determine trade behavior, there are limits to the explanatory power of any single theory. The Ricardian theory, which emphasizes the role of special characteristics such as differences in climate and—more recently—in technology, is also useful in accounting for U.S. trade behavior. The United States advantage in the production of many commodities, particularly high tech-

[13] Branson (1980) p. 76. This paper contains an excellent summary of research on the factor content of U.S. trade. For a comprehensive survey of general studies in this area see Stern (1973).

nology products, rests on superior know-how. The U.S. has maintained its share in world trade of high technology products far better than in more routine products,[14] but measures of the state of the U.S. technological lead in the major industrial sectors and how it has changed over time are inadequate.[15]

TABLE 7.—U.S. TRADE BALANCE IN R. & D. INTENSIVE AND NON-R. & D. INTENSIVE MANUFACTURED PRODUCT GROUPS, 1960–77

[In billions of dollars]

Year	R. & D. intensive			Non-R. & D. intensive		
	Balance	Export	Import	Balance	Export	Import
1960	5.9	7.6	1.7	−0.1	5.0	5.1
1970	11.7	19.3	7.6	−8.3	10.0	18.3
1971	11.7	20.2	8.5	−11.7	10.2	21.9
1972	11.0	22.0	11.0	−15.0	11.7	26.8
1973	15.1	29.1	14.0	−15.4	15.6	31.0
1974	23.9	41.1	17.2	−15.6	22.4	38.0
1975	29.3	46.4	17.1	−9.5	24.5	34.0
1976	29.0	50.8	21.9	−16.5	26.4	42.9
1977	27.6	53.2	25.5	−24.4	27.3	51.7

Source: "Science Indicators—1978", p. 161. National Science Board (1979).

C. Intra-Industry Trade

Since many commodities are both exported and imported, explaining trade grouped by industry is not always enlightening. Why does the United States export Cadillacs to the United Kingdom, and import MG's? Demand patterns and economies of scale in the production of these differentiated products are important in such intra-industry trade.[16] Commodities designed for the domestic market are also demanded abroad but in quantities that do not allow foreign producers to produce at optimal scale. We know that as foreign incomes have grown and barriers to international trade have been removed, foreign producers have been able to enjoy the economies of scale that were once available only to producers in the wealthy and integrated United States market, but again we lack studies tracking the effects of these developments on U.S. trade performance.

D. Strategic Decisions

At the level of industrial products, the influence of basic factors, such as the costs of inputs, the state of technology, and the potential for scale economies, are often outweighed by the specific strategic decisions taken by firms with respect to development, production, and marketing. And we need more case studies of the influence of the economic environment in affecting these decisions. There are cases in which U.S. management seems to have been caught flat-footed: the delays in the development of a superior U.S. sub-compact automobile, the failure of U.S. integrated circuit manufacturers to develop sufficient capacity to meet current demands, and the failure of U.S. manufacturers to match the productivity-improving automated television assembly plants installed by the Japanese in the mid-1970's. But there are also spectacular success stories. In a 1980 Wall Street Journal

[14] This is shown in Balassa, 1978.
[15] Jorgenson and Nishimizu (1978) argue that by 1973 the technology gap between the U.S. and Japan had been closed.
[16] See Krugman (1979) for a theoretical approach to the question of intra-industry trade.

article, Hout singled out "Caterpillar in construction equipment, Hewlett Packard and Tektronics in instrumentation, Dow in commodity chemicals and IBM in computers as examples of U.S. firms that have been able to meet vigorous Japanese challenges and retain global leadership." [17]

E. Innovation

The technical literature disputes the precise sources of the U.S. advantage. Does it result from the relative abundance of engineers, and scientists, the relatively large amounts spent on research and development or the market inducements to innovate in a rich economy? The strong association between these factors inhibits an exact quantification of the separate contribution of each.[18] But it is possible to provide a portrait of the kinds of goods the U.S. succeeds in exporting and those in which import penetration has been the greatest.

U.S. export industries have made large investments in research and development, and are at the technological frontier.[19] The products are often novel, require specialized production methods, and as they are still being developed, they benefit from being made in close proximity to the market in which they are sold. Staying ahead requires continuous innovation to offset the inevitable standardization of the production process and the international diffusion of technology. U.S. imports, on the other hand, are by and large mature and standardized products that can be mass-produced using skills that can be quickly acquired.

Aho and Orr of the United States Department of Labor have drawn up a demographic profile of the workforce in those U.S. industries in which exports generated the largest increase in jobs and those in which the largest numbers of jobs have been lost to imports. Workers in the import competing sample are much more likely to be female, members of minority groups, poor, blue collar and less educated than workers in manufacturing in general and in export industries in particular. Conversely, workers in export industries are more likely to be white collar, young, non-minority, highly skilled, highly educated, and highly paid.

F. Competition From the Developing Countries

The geographic location of growth influences the commodity composition of trade. In the 1970's, international economic growth was concentrated in developing economies which tend to import relatively more sophisticated U.S. capital goods while exporting labor-intensive textiles, apparel, footwear, and consumer electronics (developing countries accounted for 15 percent of U.S. manufactured goods imports in 1965 and 24 percent in 1979).[20] This has strengthened the process of international specialization along the lines of comparative advantage [21] and placed particular pressure upon declining U.S. in-

[17] Thomas Hout in the Wall Street Journal (Monday, Feb. 4, 1980). On U.S. competitiveness in TV's, see Developing World Industry and Technology (1979).
[18] On this question, see Lowinger (1975).
[19] The classic generalization along these lines is Vernon's (1966) product cycle theory.
[20] For a discussion of developing countries trade relations with the U.S. see Pearson (1979) and Sewell and Mathiesen (1980), esp. pp. 505–511.
[21] U.S. Trade Balance in R. & D.—Intensive Manufactured Products:

[In billions of dollars]

	Developing countries	Europe [1]	Canada	Japan	West Germany
1966	3.4	2.0	1.0	−0.1	
1970	4.9	3.0	2.8	−.2	0.3
1977	16.0	8.8	4.7	−3.5	−.1

[1] Includes West Germany.

Source: Science Indicators, 1978; National Science Board (1979), p. 163.

dustries in which workers are least able to adjust because of skill levels, age, and occupational and geographic immobility. Since these countries are likely to again constitute the major locus of growth in the 1980's, further developments along these lines should be expected.

G. Conclusion

Economic growth and international specialization have imposed a certain pattern on U.S. trade. The persistence of this pattern compels a re-thinking of policies to cope with the erosion of the comparative advantage of certain industrial sectors in the United States. The structural nature of this erosion makes it doubtful that small amounts of aid to affected industries can help them regain their original advantage.

IV. U.S. TRADE PROSPECTS

If present trends continue, the U.S. current account could move into substantial deficit in the 1980's. The prospective surpluses in agricultural trade and investment income could be more than offset by the cost of oil imports, the long-term tendency of the balance to decline and, in the short term the considerable decline in the price competitiveness of U.S. manufactured goods occasioned by the dollar's strength in 1980 and 1981. There are several reasons for believing that the declines in the U.S. balance of trade over the postwar period reflected many "catch-up" developments that will not be repeated. It is possible that foreign industrial economies may have exhausted the benefits of relative backwardness that allowed them to enjoy rapid productivity growth simply by adopting already existing superior production technologies. This rapid productivity growth expanded their incomes and together with reductions in trade barriers and a monetary system which progressively led to an overvaluation of the U.S. dollar, provided them with expanding markets and opportunities to realize economies of scale.

The more recent declines in productivity of industrial countries and in the growth of their national incomes, and the shift to a floating exchange rate regime, may have undermined the rate of improvement in their competitive ability. It is now argued that the United States has become a country with "cheap labor" and that foreign manufacturers will increasingly prefer to manufacture in the U.S. rather than to export to it. And if the 1980's sees a shift in the locus of growth towards the non-oil developing countries which have high propensities to absorb resources, the U.S. current account could be increased.

On the other hand, there are reasons to expect a continuation of previous trends: (1) The ever-increasing speed with which new technologies are diffused may make it harder for U.S. firms to gain even temporary advantages in new products; (2) While certain industrial

countries may be approaching U.S. productivity levels, developing countries have substantial scope to realize cost reductions with new technologies and to expand their markets; (3) Although the declines in productivity growth in other major industrial countries since 1973 have been larger than those in the United States, the U.S. productivity growth remains the slowest; [22] (4) The prices of foreign manufactures that are exported continue to decline relative to overall manufacturing costs, suggesting higher productivity growth in the export sectors; [23] (5) The trend towards foreign manufacturing in the U.S. may be exaggerated: U.S. direct investment abroad continues to dwarf foreign investment in the United States; [24] (6) To the extent that OPEC countries accumulate surpluses that they are unwilling to spend, current accounts in the rest of the world will be correspondingly decreased.

V. POLICY OPTIONS

A. The Passive Strategy

U.S. policymakers could assume that developments in U.S. international competitiveness will not be a problem for the U.S. balance of payments and adopt a passive strategy. Specifically the United States may be able to muddle through if (1) the postwar trends in the trade balance reverse themselves; (2) U.S. investment income from abroad offsets future declines in our trade balance or (3) even if the United States does run a substantial current account deficit, it is automatically financed by private capital inflows or (as most of the deficits were financed in the 1970's) by the willing (or unwilling) accumulation of U.S. government securities by foreign official agencies.

B. Positive Strategies

If it should turn out, however, that the current account deficit cannot be financed by capital inflows, the deficit itself will have to be adjusted.

Viewed from a macroeconomic perspective, since a current account deficit implies that an economy is absorbing more goods and services than it is producing, the gap between absorption and output will have to be reduced. Improvements in productivity and employment would boost output, while reductions in expenditure would have to come out of private or government consumption or investment.

Viewed from a microeconomic perspective, policies would have to make the production of tradeable (exports and import-competing) goods more attractive and the consumption of these goods less attractive. This could be achieved either through protectionist measures such as tariffs and quotas or through an improvement in the relative competitiveness of U.S. costs via an exchange rate devaluation or a lower U.S. relative inflation rate. A sound policy to adjust the current account, therefore, requires a coordinated use of instruments to change both the levels and the composition of production and expenditure.

[22] From 1973 to 1978, for example, output per manhour in U.S. manufacturing grew at an average annual rate of 1.0 percent. In the other six major industrial countries the average was 2.6 percent. See Lawrence, (1980), p. 32.

[23] From 1975 to the second quarter of 1979, for example, U.S. export price competitiveness as calculated by the International Monetary Fund failed to improve, although U.S. wholesale prices rose by 5.2 percent less than dollar prices in other industrial countries measured in dollars.

[24] In 1980, for example, the value of U.S. direct investment abroad was $18.5 billion while foreign direct investment in the U.S. was $10.9 billion. Source: Survey of Current Business, U.S. Department of Commerce, June 1981, Table 5, p. 57.

When a person discovers that his current expenditures exceed his income he has several choices: (a) he can finance this deficit by (1) increasing his indebtedness, or (2) selling some of his assets; or (b) he can adjust the deficit by either (1) working harder and raising his income, or (2) by spending less. Of course, if he decides to borrow more he may find that people are only willing to lend at higher rates of interest than he currently pays. Similarly, if he sells some of his assets or more of his labor, he might have to lower his prices to induce others to buy. These same options confront the nation.

1. MACROECONOMIC POLICIES

Since the current account is the difference between national income and expenditure, to reduce a deficit on current account either income will have to be raised or expenditure lowered (not absolutely—but relative to what it would otherwise be, given income).

The most appealing way of increasing the current account lies in raising income by improving productivity. But, in recent years the United States productivity performance has declined markedly and there is little agreement over why the decline has occurred and how it might be rectified. Moreover, some of the balance-of-payment benefits of increases in productivity could be eaten up by higher wages and profits. In the absence of effective productivity-raising measures, the adjustment will have to take the form of reduced expenditures on goods and services. Adjustment policies should aim at achieving this inevitable belt-tightening in the most efficient and equitable manner possible.

Reductions in expenditure could come out of private and/or public consumption and/or investment and will probably have to come out of all of these categories. It will be tempting and perhaps politically expedient to reduce private investment and to postpone the reduction in current standards of living. But an alternative and promising long-run strategy would be to place the major burdens of adjustment upon both government and private consumption.

2. FISCAL-MONETARY POLICY MIX

As the nation attempts to fight inflation it is likely that the overall posture of both fiscal and monetary policy will have to be relatively restrained in the next few years. But the proportions in which policy-makers choose to rely on fiscal and monetary policy to achieve this restraint could have an important influence on the current account of the balance of payments.

Budget deficits coupled with an extremely tight monetary policy force the government to borrow to cover its deficit, while raising the costs of doing so by higher interest rates. The higher interest rates that result from slower monetary growth encourage foreigners to lend to the United States and induce capital inflows which strengthen the dollar. But this strengthening of the dollar has a particularly adverse effect on the international competitiveness of U.S. firms, and is likely to cause a deterioration in the current account and to channel investment away from U.S. firms competing in international trade both at home and abroad. High interest rates would also adversely affect U.S. investment generally unless tax relief to firms to offset this effect is

provided. The favorable effects of this policy on the current account depend on the extent to which lower taxes improve productivity and higher interest rates stimulate savings.

The alternative strategy keeps interest rates lower through a relatively tighter fiscal policy and an easier monetary policy. Since relatively lower U.S. interest rates lead to smaller capital inflows, this mix results in a weaker dollar. The smaller government deficit (or larger surplus) represents increased public savings, while low interest rates encourage private capital formation. The improvement in international competitiveness brought about by a weaker currency boosts the current account and channels investment into U.S. firms involved in international trade.

3. IMPROVING PRICE COMPETITIVENESS

An important component of a policy to increase the balance on current account is an improvement in U.S. relative price competitiveness. This could be achieved either by a devaluation of the dollar (assuming that inflation in the United States compared to the rest of the world remains unchanged), or a relatively lower inflation rate in the United States (assuming that exchange rates and inflation in the rest of the world remain constant).

The role of a lower U.S. inflation rate in improving the balance of payments cannot be overstressed. An improvement in the relative U.S. inflation performance (that is not offset by a dollar appreciation) would also have the virtue of inspiring greater confidence in the dollar as an asset.

In retrospect, some of the dollar changes since 1971 have been inappropriate and have had to be reversed. The two-to-three year lags with which the relative price effects operate are a major drawback. Private and public participants may allow short-run considerations to divert their attention from the long-run fundamentals. In the short run, the dollar may be boosted by higher interest rates, relatively slow growth in the United States (which reduces our import demand), or even by a decline in U.S. price competitiveness. (In the short run relatively higher U.S. prices may actually increase the current account because of the sluggish response of trade volumes to relative prices.) Policymakers are lulled into a false sense of security by the apparent improvement in the external accounts, and by the lowering of the price level that an exchange rate appreciation brings about. But the dollar will weaken with time, as interest rates decline, the U.S. economy recovers, and the delayed operation of declines in price competitiveness affect trade volumes. Sustained growth could prove difficult in the face of the inflationary effects of a weaker dollar and the need to adjust the external accounts.

4. A NEW INDUSTRIAL POLICY

There is a widespread view that the United States needs to do more than rely on macroeconomic policies to improve its international competitiveness. Many have called for a new comprehensive industrial policy. At one level there is a broad consensus that calls for: (a) improved cooperation between business, labor and government, (b) measures to increase capital formation, (c) reform of the tax system,

(d) the repeal of unnecessary government regulations and (e) placing a higher priority on U.S. international competitiveness. But there is substantial disagreement about the specific methods by which these goals are to be achieved. Three approaches to industrial policy are usefully distinguished.

a. The defensive approach

The defensive approach entails direct government support, particularly to basic U.S. industries which have fared poorly in international competition. The nature of the assistance desired often involves the use of tariffs, quotas and/or other selective forms of protection.

Perhaps the disillusionment with free trade reflects the fact that economists may have oversold free trade by promising things that it cannot deliver. Free trade does not guarantee that the gains accruing to a country from trade will not decline over time. Just as a country which was the world's sole producer of a rare metal could find that discoveries abroad lowered its monopoly returns, so a loss in the United States technological lead can reduce U.S. gains from trade. But the fact that the gains from free trade are diminishing does not imply that they are zero or that prohibitions on trade will lead to a preferable outcome. Gains are still possible from specializing in the production of goods and services that the United States can produce relatively well and exchanging them for goods and services others can produce relatively well.

While a tariff designed to protect a particular industry might well be successful both in maintaining domestic employment and in preventing a decline in the current account balance, it will have its costs. In the first place, U.S. consumers of that product will lose the benefits they could derive by obtaining it from a cheaper source; secondly, the U.S. exporters who use that product directly (or indirectly as an input) will find their costs rising relative to those of their international competitors; and in the third place, other U.S. firms lose the benefits they might have derived from an alternative way of correcting the problem—an improvement in overall competitiveness through lower relative U.S. prices.

Economists argue that protecting particular groups punishes the productive at the expense of the unproductive. By imposing import restrictions, the argument continues, policymakers are favoring particular procedures over others. Moreover, it is costly to perpetuate industries which can no longer compete. The strength of the trends we have observed over the past thirty years indicates that there are fundamental forces in operation that will not easily be reversed.

b. The offensive approach

The second type of strategy is offensive. The government targets particular "sunrise" industries for special subsidies and attention. The Japanese achievements in trade are singled out as examples of how successful such a policy might be. But an approach that succeeds in one set of circumstances may not succeed in another. It is possible that a concerted plan will succeed when the development pattern involves a clear path, but that it may be less effective when the path is inherently uncertain. At the technological frontier there is no compelling reason to believe that government officials will be better informed than the private sector about where the breakthroughs will be. And a diversified

strategy is more likely to succeed than one placing faith on the judgment of a central committee.

Moreover, simply because the United States has a comparative advantage in high technology products does not make the current account effects of a dollar spent on this activity greater than a dollar spent in subsidizing an import-competing industry. Similarly, simply because the United States has a substantial energy deficit does not imply that a dollar spent on energy conservation will necesarily be the best way of increasing the current account.

Government assistance for research and development is one measure frequently cited as necessary to improve U.S. international competitiveness.

A strong case can be made for the governmental promotion of research. As those generating knowledge will not appropriate the full social benefits of their findings, there is reason to believe that a private market system will allocate insufficient resources to research. But while some of the money spent in encouraging research and development may increase exports, this need not necessarily be the case. Much of the U.S. research and development effort has been devoted to the development of military technology which is not to be sold abroad. The distinction between invention and innovation is important. While subsidies to research and development may encourage the discovery of new technologies it will not guarantee that the economic application of such technologies will take place in the United States. This will depend upon relative production costs here and abroad, and will be affected by the real value of the dollar. A more competitive dollar will induce companies to take advantage of the highly skilled U.S. labor force and locate here.

c. The adaptive approach

The third approach to industrial policy is adaptive. The government undertakes measures to encourage adjustment rather than attempting to freeze production in existing patterns or to promote development in particular industries. Declines in U.S. competitiveness in particular sections impose considerable burdens upon workers and owners of affected industries. Society should assist the people involved to make the adjustments to other kinds of activities. This strategy involves providing adjustment assistance and, at times, delaying the pace of change. But such assistance should be temporary, and, ideally, implemented so that it is self-liquidating. Wherever possible temporary assistance should aim at inducing a reallocation of producers into other activities rather than at maintaining them in their current activities. It might be done in the form of temporary subsidies to the producers rather than in the form of higher prices which impose costs on both consumers and producers.

An adaptive policy would also ensure a favorable environment for international trade in general and U.S. performance in particular. International competition must be perceived as fair and the "rules-of-the-game" strictly enforced. In addition, regulations that may actually hinder U.S. export performance such as anti-bribery regulations, taxation of U.S. nationals abroad, restrictions on agricultural, military, and high-technology exports, and anti-trust regulations should be reviewed in terms of costs and benefits.

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Much emphasis and publicity has been given to the argument that American manufacturers are inward-looking and are unaware of many profitable export opportunities. Firms have been castigated for their parochial attitudes and export-promotion drives have been launched. While such activities might have an effect upon a few corporations which are marginal exporters, they cannot be relied upon. They rest upon a premise that is incorrect. Past declines in U.S. competitiveness have not been the result of ignorance. In fact, these reflected an awareness that at previous exchange rate levels it was more profitable to manufacture many of the products abroad than in the United States.

The most powerful influence upon performance in trade are relative costs. Increased expansion in modern capacity, increased U.S. expenditures on research and development, and a drive to find new markets (or to recapture old ones) will all take place when firms discover they can undersell their competitors by manufacturing in the United States. An improvement in relative U.S. costs would provide the incentives for allocating more U.S. resources to the production of tradeable goods; a reduction in aggregate domestic expenditure (for example, by a smaller government deficit or increased personal savings) would free products for export.

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UNITED STATES-JAPAN TRADE RELATIONS

By Dick K. Nanto *

Introduction

During the 1970's, commercial aspects of the United States-Japan alliance began to dominate the dialogue between the two nations. Particularly troublesome have been chronic bilateral trade deficits with Japan, allegations of Japanese protectionism, and rapid incursions by Japanese exports into U.S. markets. Economic problems (along with defense issues) now stand as major stumbling blocks in a relationship that otherwise is characterized by broad agreement, synergistic interaction, and complementarity.

Although economic disputes occasionally adversely affect government, military, and cultural relations, the United States and Japan enjoy close economic and political ties. As the two largest economies in the noncommunist world, both countries find common ground in economic systems based primarily on market principles and political systems based on democracy. The United States is Japan's largest export market, while Japan trails only Canada as a market for U.S. products. These economic relationships spell interdependence. The economic well-being of each country is partially dependent on the other.

Japan's re-entry into the select club of economically powerful countries of the world has been recent. Some of Japan's success in attaining this position can be attributed partly to a government policy of fostering domestic industry through rapid technological change, a high rate of investment, export promotion, and import protection. Now that Japan has developed to a point where it is challenging the Soviet Union for second place among world economies, however, it is being forced to abandon the protectionist economic structure that was more appropriate to the immediate postwar era when the Japanese economy was weak, struggling through one balance-of-payments crisis after another, and below world-class levels of competition in heavy industries and consumer goods.

With virtually no natural resources and land enough to produce only half of its food, Japan tends to view exporting as vital to national survival. A philosophy of "export or perish" permeates society. Recently rising international prices of petroleum and grains have also forced Japan to mount an extensive export drive in order to generate the foreign exchange necessary to pay for its soaring import bill.

This surge in Japanese exports combined with a large and chronic U.S. trade deficit with Japan has been a catalyst for renewed protectionist pressures in the United States. As each new Japanese export

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product makes significant inroads into U.S. markets, a loose coalition grows of domestic industries who have been, currently are, or expect to be jostled by Japanese competition. This coalition can wield considerable political power and often can galvanize public opinion to oppose not only imports from Japan but the basic U.S. support of an open world trading system. Hence, current U.S. economic problems with Japan contain seeds of damage for the entire system of open international trade. As Representative Vanik stated, ". . . the extraordinary one-sided nature of our bilateral trade has been the single biggest cause of the erosion of good will and support of trade in the United States.[1]

Several aspects of U.S. bilateral trade with Japan call for government intervention into what is essentially private economic activity. First, past experience has shown that trade imbalances can be altered by government negotiations.[2] Second, rapid surges into U.S. markets by certain highly competitive Japanese exports have brought intense public awareness and criticism that should be addressed. Third, issues concerning protectionism and "unfair" trading practices by countries can be resolved only through government action and not by market forces. And fourth, both countries view their trading relationship as extremely important and are willing to devote considerable attention and resources to it.[3]

The 95th Congress emphasized the importance of achieving a significant reduction in Japan's external trade surpluses. The 96th Congress pressed for specific measures which included support for the Multilateral Trade Negotiaions, the Government Procurement Code, increasing Japanese import quotas on beef, citrus products, and leather, and bringing to public attention many of the policies of the Japanese Government considered to be protectionist and discriminating against U.S. exports. The 96th Congress also assisted in securing protection for certain domestic industries, such as steel, that were subject to intense competition from Japan.

For the 97th Congress, actions will undoubtedly continue to focus on specific irritants and problems in the U.S.-Japan trade relationship. The dominant theme, however, will likely shift gradually from treating individual cases to pursuing broader measures that will bolster U.S. competitiveness and productivity not only in industries that compete with Japan but throughout the U.S. economy. A consensus is emerging among American opinion leaders that the bilateral economic disputes with Japan are as much a symptom of a problem as a problem itself. In other words, if U.S. industries now under competitive pressures from Japan can increase their productivity, enhance product design, tighten up on quality control, and reduce costs so as to bolster their international competitiveness, imports from Japan would not be such a large and irritating problem. Short-term measures to reduce the bilateral trade deficit with Japan, however, will likely command considerable attention of Congress.

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[1] Vanik, Charles A. Japan-United States Trade. Remarks in the House. Congressional Record. v. 126, Nov. 17, 1980. p. 10710.

[2] Joint Statement by Ambassador Strauss and Minister Ushiba. June 2, 1979 (mimeograph).

[3] Samuelson, Robert J. "U.S., Japan Find Old Relationships Have Unraveled." National Journal, v. 11, June 1979, p. 1071. Japan Ministry of Foreign Affairs. "The Close Relationship Between Japan and the United States," 1979, mimeograph, pp. 1–14.

Background

General Economic Positions of Japan and the United States

The U.S. public is just now fully recognizing Japan's rapid rise to power. Many people still view Japan as a developing Asian nation recovering from World War II and competing successfully in international markets mainly by slavish imitation or government subsidies. Because of this recognition lag, numerous Americans find it difficult to perceive completely that Japan can compete with U.S. industries in steel, automobile, television receivers, and a host of other products without resorting to unfair trade practices. Some also find it hard to conceive that virtually all of the Japanese exports shipped to the United States were initially manufactured for sale in Japan's domestic markets.

Even many Japanese are surprised at their own successes. Many still view their country as economically weak and needing protection from U.S. competition. Some Japanese have even argued that Japan's large trade surpluses can be attributed to Japan's inherent weaknesses and not strength.[4]

The opposite can also be found. Having discovered Japanese economic strength in certain export industries, many people in both Japan and the United States have characterized Japan as "Number One."[5]

In fact, neither position is completely accurate. In general, Japan's rapid economic growth over the past three decades has enabled it to almost catch up with the United States in terms of average income per capita. Certain Japanese industries (steel, shipbuilding) are generally more modern and efficient than their U.S. counterparts, but specific U.S. plants are just as modern as those in Japan. Other Japanese industries (retailing, farming, pharmaceuticals) are less efficient than those in the United States. Japan, however, has a momentum and a recent history of rapid growth that gives it an advantage in terms of future growth. Few students of the Japanese economy would be surprised if it surpassed the United States in terms of per capita income within this decade.

By 1980, Japan's gross national product reached the $1 trillion level (one not reached by the United States until 1971). This compares favorably with the U.S. GNP of $2.5 trillion. With a population about half that of the United States, Japan's GNP per capita averages about $9,000 per person compared with about $11,000 per person in the United States. The average wage in manufacturing in Japan in 1980 was $5.71 compared with $9.89 in the United States.[6] Between 1974 and 1980, Japan's real economic growth rate averaged 4.7 percent as compared with 2.0 percent in the United States. Japan's rate of consumer price inflation over the same period averaged 7.4 percent compared with 8.4 percent for the United States. In 1980, Japan exported 15.1 percent of its GNP as compared with 9.9 percent for the

[4] Onitsuka, Yusuke, and Toru Toyoshima. Economic "Weaknesses" and International Responsibilities. Oriental Economist, v. 96. June 1978. pp. 12–13.

[5] Ando, Hiroshi. Have Japanese Enterprises Really Surpassed US Enterprises? Voice, May 1980. Traslated in American Embassy, Tokyo. Summaries of Selected Japanese Magazines. August 1980. p. 1–16. Ezra F. Vogel, Japan as No. 1, Lessons for America, Cambridge, Mass., Harvard University Press, 1979.

[6] U.S. Department of Labor, Bureau of Labor Statistics. Estimated Hourly Compensation of Production Workers in Manufacturing, Fourteen Countries, 1975–1980. Unpublished data, November 1980.

United States. In dollar volume, however, the United States exported 65 percent more than Japan.[7]

Over the 1975–80 period, the United States incurred a cumulative merchandise trade deficit with Japan of $45.6 billion. For 1980, the deficit reached $10.4 billion, which was up from the $8.6 billion deficit in 1979 but below the record $11.6 billion deficit in 1978. For the first half of 1981, the deficit rose to $7.2 billion. With the strength of the dollar vis-a-vis the yen, the deficit for all of 1981 is likely to set a new record.

TABLE 1.—UNITED STATES-JAPAN MERCHANDISE EXPORTS, IMPORTS AND BALANCES, 1975–81
(2d QUARTER)

[In billions of U.S. dollars (f.a.s.)]

	1975	1976	1977	1978	1979	1980	1981 (2 quarters)
Merchandise imports from Japan	12.41	15.53	18.57	24.54	26.26	31.22	17.99
Merchandise exports to Japan	9.57	10.20	10.57	12.96	17.63	20.81	10.79
U.S. balance	−1.69	−5.34	−8.00	−11.58	−8.63	−10.41	−7.20

Source: U.S. Department of Commerce, Survey of Current Business.

This trade deficit with Japan has been a major contributor to the total U.S. merchandise trade deficit. From an economic point of view, however, the bilateral deficit in merchandise trade with Japan should not be an overriding concern as long as total U.S. trade in goods and services is roughly in balance. Merchandise trade is only part of the total flow of international economic resources, and Japan is merely one country among many trading partners.[8]

For the United States, the deficit in merchandise trade is generally offset by a surplus in trade in services, and the deficit with Japan is usually matched by a surplus with the countries of Western Europe ($20.5 billion in 1980). Likewise for Japan, the surplus trade with the United States is largely offset by a deficit in trade with petroleum exporting countries.[9]

One might argue that the United States has no obligation to pay for Japan's oil imports with jobs of American workers. By the same logic, however, Europeans can argue that they have no obligation to pay for U.S. imports from Japan with jobs of European workers. The validity of either argument appears suspect, in as much as deficits in one trade account generally are offset by surpluses in another.

For policy purposes, overall trade balances seem to be more important than bilateral balances. Still the magnitude of the deficit with Japan along with the political fallout it causes and its amenability to policy thrusts means that it will continue to command attention. The deficit also provides an opportunity and rationale for the United States to insist that Japan take measures to reduce any remaining barriers to U.S. exports there.

[7] In 1974, consumer prices in Japan increased by 24.3 percent. By 1979, however, that rate had fallen to 3.6 percent but rose to 8.0 percent in 1980. Based on data in International Monetary Fund, International Financial Statistics, July 1981, pp. 222–225, 406–409.

[8] In terms of the balance on current account (trade in goods and services plus unilateral transfers), in 1980 the United States had a surplus of $3.72 billion, while Japan had a deficit of $10.8 billion.

[9] Japan's current account deficit reached $10.8 billion in 1980. Computing both imports and exports on a f.o.b. basis, however, changes Japan's merchandise deficit to a surplus of $2 billion. See A. E. Cullison, Japanese BOP Gap Hits Record in 1980, Journal of Commerce, January 21, 1981, p. 13.

Japan faces two basic problems that appear to make it reluctant to unilaterally reduce its trade surplus with the United States. First, Japan has spent most of its modern history leaping from one balance of payments crisis to another. It tends to view trade surpluses as transitory and, hence, is hesitant to grant long-term concessions to rectify what it views as a short-term phenomenon.

Second, Japan's large government budgetary deficit ($55 billion in fiscal year 1981 or about 5 percent of GNP)[10] has been a major hindrance to the adoption of policies more favorable to U.S. exports. This fiscal constraint has kept Japan from increasing defense expenditures faster, switching from a program of agricultural price supports to direct subsidies in order to buy more U.S. food products, or adopting a program of emergency imports from the United States. The deficit also has kept the government from adopting expansionary economic policies, perhaps the most effective way to increase Japanese imports.

In terms of specific commodities, as shown in Table 2, the major U.S. exports to Japan consist of agricultural products, industrial supplies and materials, and capital goods. Japanese exports to the United States consist mainly of automobiles, consumer durables, and capital goods. On appearance, this trading relationship appears to be one typical of that of a less-developed country (the United States) serving as a colony for a more-developed country (Japan). Actually, however, the U.S. agricultural sector with its advanced technology and mechanization can hardly be considered to be typical of that in a less-developed country. The United States also exports many high technology items to Japan.

The bulk of the current bilateral trade deficit with Japan can be traced to automotive vehicles and parts, although the deficits in consumer and capital goods are also rising. Table 2 shows the importance of automobiles in Japan's exports to the United States. In 1980, Japan's exports of automotive products here were more than double U.S. exports of agricultural products there.

TABLE 2.—UNITED STATES MERCHANDISE TRADE AND BALANCES WITH JAPAN BY COMMODITY GROUP 1979 AND 1980

[In billions of U.S. dollars (f.a.s.)]

Commodity	Imports		Exports		Balance	
	1979	1980	1979	1980	1979	1980
Total	$26.2	$30.7	$17.6	$20.8	−$8.6	−$9.9
Foods, feeds, beverages	.2	.3	4.7	5.4	4.5	5.1
Industrial supplies and materials	5.3	5.9	7.7	9.5	2.4	3.6
Capital goods, except automotive	5.7	6.6	3.5	4.1	−2.2	−2.4
Automotive vehicles, parts, engines	9.3	11.4	.2	.2	−9.1	−11.2
Consumer goods (nonfood) except automotive	5.6	6.2	1.0	1.2	−4.6	−5.0
Other	.2	.3	.4	.4	.2	.1

Source: U.S. Department of Commerce. Highlights of U.S. Export and Import Trade. (These data differ slightly from those from the Survey of Current Business in tabje 1.)

Common Interests

The United States-Japan economic alliance is rooted in a commonality of interests. Both countries play an important role in the international economy. As the two largest non-communist economies, both

[10] Government Draft of Fiscal 1981 Budget. Fuji Bank Bulletin, v. 32, April 1981, p. 70.

countries have an interest in maintaining a viable, accessible, and growing international trade system. Both countries also share an interest in maintaining peace and security in the world, a stable international currency regime, and a world political system that is conducive to unfettered world commerce.

Each country also shares a vital interest in reducing its respective dependence on imports of petroleum. The large oil import bills faced by both countries underlie many of the problems each has in international trade. For Japan, the rising cost and insecurity of oil supplies are a major impetus behind its export drive and its reluctance to import more. For the United States, it is a major cause of the overall imbalance in merchandise trade.

During 1980, the United States imported an average of 5.2 million barrels per day of crude oil, while Japan averaged 4.4 million barrels per day. The cost of petroleum and product imports for all of 1980 for the United States reached $75 billion, while that for Japan approached $60 billion.[11] Reductions in these amounts would give each country some leeway to accommodate other imports and more latitude in determining international trade policies. A major disruption in oil supplies, moreover, could pit the United States and Japan against each other in a world-wide scramble for petroleum.

The large trade volume flowing between the United States and Japan implies that economic conditions in one country can influence those in the other. The Organization for Economic Cooperation and Development, for example, has estimated that a one percent increase in GNP in the United States causes Japan's balance of trade to improve by $440 billion.[12]

Trade Friction and Comparative Advantage

International trade friction between the United States and Japan is perhaps inevitable for two economies so large, diversified, and dynamic. Each country has the potential to produce almost any product manufactured by the other.

In general, the United States holds a comparative economic advantage over Japan in the production of agricultural and certain high technology products and in items aimed at a market in which space is abundant and energy is relatively cheap. Japan holds a comparative advantage in moderately labor-intensive manufactures that require sophisticated technology and in products aimed at a market in which space is scarce and energy is relatively expensive.

Neither country, however, holds such a complete advantage in any product that the other does not attempt to produce it at all. Hence, in either country imports will generally compete with domestic production, and increases in import sales will usually occur at the expense of domestic employment and profits (either actual or potential). As a result, even those products in which the United States has a clear and decided advantage (beef production for example) compete with a

[11] U.S. Central Intelligence Agency. National Foreign Assessment Center. International Energy Statistical Review. July 28, 1981, pp. 5–6. U.S. Department of Commerce. Highlights of U.S. Export and Import Trade. December 1980, p. 89. Bank of Japan. Economic Statistics Monthly. March 1981, p. 134. For more information, see Ronald A. Johnson. The Impact of Rising Oil Prices on the Major Foreign Industrial Countries. Federal Reserve Bulletin, v. 66, October 1980, pp. 817–824.

[12] In 1978 dollars. See OECD. The OECD international linkage model. OECD Economic Outlook, January 1979, p. 22.

domestic industry in Japan. Likewise, those products in which Japan has a clear and decided advantage (radio production for example) compete with a domestic industry in the United States.

Comparative advantages, moreover, change with technology. A comparative advantage often can be created simply by installing modern equipment. In high technology industries in particular, comparative advantage is often less dependent on natural or labor resource endowments than on machines, research, and marketing.

A primary cause of the trade friction between the United States and Japan is that comparative advantages are shifting. Many industries in which the United States traditionally has held a comparative advantage are being challenged by Japan (automobiles, steel). Japan also sees its comparative advantage being eroded by imports from newly developing countries in Asia (textiles, light manufacturing, and even steel).[13] Japan, therefore, is attempting to shift more of its production to high technology and knowledge-intensive industries—precisely those in which the United States has been preeminent.

As the U.S. and Japanese economies continue to develop the same productive capacities, sales competition between the two countries will intensify. Mercantilistic and nationalistic attitudes are likely to enter as persons on both sides tend increasingly to view such competition as an international zero-sum game in which sales gains by one nation are considered to be a loss by the other. With the prospect of such competition increasing, the methods and institutions currently being developed to resolve urgent bilateral trade problems will lay valuable groundwork for future amicable solutions to difficult economic problems.

Japanese Protectionism

Owing largely to the Multilateral Trade Negotiations (MTN) and intense bilateral bargaining by the United States, Japan's protectionist policies are rapidly eroding. Under the MTN tariff concessions (to be phased in over the first seven years of the 1980's), Japan's tariffs on total industrial imports are to fall from an average of 5.0 to 2.5 percent. Comparable U.S. tariffs are to fall from an average of 6.1 to 4.2 percent.

Under the MTN agreement, Japan made important tariff concessions in key U.S. export sectors of computers, semiconductors, film, electrical machinery, paper, and automobiles. The United States reduced its tariffs on electrical machinery and power equipment, scientific instruments, photographic equipment, office and computer equipment and other items of special interest to Japan.[14]

According to a recent report from the House Ways and Means Committee, "Japan today is generally an open trading nation, although some very tough, residual attitudes of protectionism remain."[15] A study by Arthur D. Little, a consulting firm, also concludes that with respect to non-tariff barriers, among the U.S. firms that have successfully penetrated the Japanese market, the majority believe that most deliberately discriminatory policy and bureaucratic barriers

[13] Lewis, John. Industrial Japan. "Basics, the Cost of Survival Is Going to Come High." Far Eastern Economic Review, v. 110, Dec. 5, 1980, pp. 46–49.

[14] U.S. Department of Commerce. "Tokyo Round Tariff Reductions." Washington, U.S. Government Printing Office, 1980, pp. 1–3.

[15] U.S. Congress. House. Committee on Ways and Means. United States-Japan Trade Report. Committee Print. 96th Congress, 2d session. Washington, U.S. Government Printing Office, 1980, p. 1.

have been dismantled. Most of the U.S. companies which have been less successful in Japan, along with and many U.S. governmental officials and American journalists, however, believe that Japan remains committed to import exclusion at the governmental policy and bureaucratic level.[16]

The Japanese Government views its economy as open because of the low level of its customs duties and a smaller number of restricted import items than exists in overseas nations.[17] Japan, for example, can claim that its market for beef is not more restricted than that in the United States, because both countries maintain import quotas. This focus on a number of restricted items, however, says nothing about the intensity of those restrictions. Japan's import quotas tend to be much more severe and less open to new entrants than those in the United States.

In general, however, much of the protectionist structure which existed in Japan in the 1950's and 1960's has been dismantled, although serious barriers still exist. Japanese tariffs are not a major barrier to most U.S. exports. The remaining non-tariff barriers and protectionist attitudes among certain government officials are also not considered to be a major cause of the chronic trade imbalance between the two countries.[18] Non-tariff barriers can, however, prevent rapid increases in U.S. exports to Japan in certain products and, thereby, contribute indirectly to the trade imbalance.

Specific Bilateral Trade Issues and Congressional Options

Despite the general public focus on disagreements and compliments in the U.S.-Japan trading relationships, most bilateral trade issues have been resolved in a manner generally agreeable to both sides. The problems remaining, however, tend to be more difficult than those already solved.

Motor Vehicles

During the 96th Congress, trade in motor vehicles emerged as one of the most serious economic trade problems. The most publicized aspect of the problem came in the increased competition in automobiles imported from Japan. Another issue, however, was the limited sales by U.S. automakers in the Japanese market. A related issue was a reclassification by the United States of imports of light pickup trucks, which resulted in an increase in the applicable U.S. tariff from 4 to 25 percent.

Sales of imported passenger automobiles from Japan doubled from 808,000 units in 1975 to 1,770,000 units in 1979. During 1980, imported car sales from Japan reached 1,908,000 units—up 7.8 percent over 1979 and accounting for 21.4 percent of all new car sales.[19]

This vigorous market penetration came while the U.S. industry was suffering from a large downturn in demand because of the 1980 reces-

[16] Arthur D. Little, Inc. "American Views Concerning Japanese Non-tariff Barriers to Trade." Japanese National Institute for Research Advancement Report. No. NRC–78–12, May 1979, pp. 1–6.

[17] Japan. Economic Planning Agency. "Annual Report of the Economy." Summary. (Fiscal 1980). Tokyo. Foreign Press Center, 1980, p. 48.

[18] Little, op. cit., p. I–17. Also see U.S.-Japan Trade Study Group. A Special Progress Report. Tokyo, April 1980, mimeographed, p. 1.

[19] Based on Automotive News, July 12, 1981, p. 41, and Ward's Automotive Yearbook, 1977, p. 43.

sion and continuing inflation as well a massive switch by consumers to smaller and more fuel-efficient automobiles. As a result indefinite layoffs in the industry reached a peak of some 250,000 in July 1980, and the four U.S. automakers closed their balance sheets in 1980 with combined losses of more than $4 billion.[20]

On November 12, 1980, the U.S. International Trade Commission rejected petitions by the United Auto Workers and Ford Motor Company for temporary relief from import competition in passenger cars and trucks. The Commission determined that imports of automobiles and trucks were not a substantial cause of severe injury to the domestic auto industry. The recession and general downturn in the demand for motor vehicles were considered to be more important causes of injury. Under current law, this implied that protection from imports was not justified.

The Commission estimated that more than 80 percent of the actual decline in vehicle sales in 1979 and over 60 percent of the decline during the first half of 1980 were attributable not to imports but to declining overall demand and consumer switching from large to small cars.[21]

This decision shifted the focus of efforts to gain protection for the auto industry from the Commission to Congress and the Administration. In May 1981 in response to the threat of legislated import quotas and in an attempt to quell the dispute prior to the talks between President Reagan and Prime Minister Suzuki, the Japanese government announced that it would voluntarily reduce passenger car exports to the United States by 7.7 percent to 1.68 million units during the period April 1, 1981 to March 30, 1982. The plan allows for an increase in the 1.68 million level by 16.5 percent of any U.S. market growth in the following twelve-month period and for monitoring to prevent any export surges during the third year.[22]

These voluntary restraints, however, contain loopholes by which an increase in sales of Japanese cars in the United States could still occur. The announcement covers Japanese exports but not inventories already existing in the United States. Japanese cars re-exported from third countries also are not included. Exports to Puerto Rico, which is in the U.S. customs territory, have been set separately at 70,000 units. The quota for vans and station wagons, considered to be commercial vehicles in Japan, moreover, was established separately at 82,500 units.

These voluntary export restraints are not expected to cause any large increase in employment in the U.S. auto industry. They have, however, reduced the political tension over the issue and should give the automobile market some stability.

Other measures being considered to assist the automobile industry are further deregulation, providing a consumer subsidy or income tax credit for purchasing a new car, establishing more rigid import quotas on automobiles and trucks, imposing an additional excise tax on imported automobiles, allowing an investment tax credit for the purchase of fuel-efficient automobiles, prohibiting any extension of credit for the purpose of financing the purchase of a Japanese car, and providing for cooperative research and development on automotive technology.

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[20] Ward's Automotive Yearbook, 1981, pp. 13–14.

[21] U.S. International Trade Commission, "Certain Motor Vehicles and Certain Chassis and Bodies Therefor," Washington, USITC, 1980, p. 26.

[22] A. E. Cullison, "Japanese Gov't Sets Auto Export Quotas," Journal of Commerce, June 25, 1981, pp. 1, 11A.

The United Auto Workers, moreover, is now favoring legislation requiring that automobiles sold in high volumes in the United States contain a certain percentage of domestic parts and labor.[23] The purpose behind such a local content law would be to induce foreign manufacturers to set up assembly plants in the United States and to keep U.S. automakers from buying original equipment abroad.

A local content law for automobiles would tend to increase autoworker employment and raise profits in U.S. automotive supplier firms. On the negative side, however, it also would tend to boost costs for U.S. automakers, require extensive bookkeeping, and invite retaliation from abroad.[24]

The analogue of U.S. automaker concern over the rapid penetration of the U.S. market by Japanese automobiles is the inability of U.S. auto manufacturers to make sizable inroads into the Japanese market. While tariffs on imported automobiles and parts into Japan have been temporarily suspended, no non-Japanese automaker has succeeded in selling cars in Japan to any major extent. In 1979, only 16,705 U.S.-built passenger cars were sold in Japan. For 1980, sales were even lower.[25]

The poor sales record of American cars in Japan has been attributed to Japanese protectionism during the 1950's and 1960's which prevented a network of dealerships from being established, unsuitability to the Japanese market (poor fuel economy, left-hand drive, larger size, etc.) a higher commodity (excise) tax (22.5 percent for large cars as compared to 17.5 percent for small cars), costs of alterations to Japanese standards, government inspection procedures, and a poor distribution system. These factors can double the price of an American car in Japan.[26] Congressional efforts in this respect will continue to be directed toward lowering the commodity tax on larger cars, reducing inspection requirements, and generally facilitating entry by U.S. cars into the Japanese market.

A third issue relating to motor vehicles is the enforcement of a 25 percent tariff on light pickup trucks imported into the United States. The U.S. Customs Service had been allowing Japanese pickup trucks without their cargo beds attached to enter the United States as automotive parts with a 4 percent duty instead of the 25 percent duty of finished trucks. In many cases, importers would detach the cargo bed before sending the pickup truck through customs and then reattach it later.

On May 20, 1980, the U.S. Treasury Department ruled that such cab and chassis units were to be classified as trucks and not truck parts. On August 21, 1980, the higher 25 percent tariff came into effect. (The tariff on passenger cars from countries other than Canada remains at 2.9 percent.) Japanese truck producers have protested this action.

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[23] Douglas A. Fraser. Speech to the Sixth Annual Automotive News World Congress, July 20, 1981.

[24] U.S. Library of Congress. Congressional Research Service. "Local Content Laws and Automobile Imports." Report No. 81-191E (By Dick K. Nanto). Aug. 11, 1980. pp. 2-4.

[25] Imported Cars Sell at a Record Pace in Japan. Automotive News. Feb. 4, 1980. p. 49. John Hartley. "Japanese Auto Sales Drop in Home Market." Automotive News, Feb. 16, 1981. p. 16.

[26] U.S. General Accounting Office. "United States-Japan Trade: Issues and Problems." Report by the Comptroller General of the United States. Washington, U.S. General Accounting Office, 1979, pp. 45-56.

All three issues, Japanese exports of automobiles to the United States, barriers to U.S. automobile sales in Japan, and the 25 percent tariff on imported pickup trucks will continue to command attention during the 97th Congress.

Telecommunications Equipment

Implementing the Government Procurement Code with Japan as agreed to under the Tokyo Round of the Multilateral Trade Negotiations touched off a protracted and somewhat acrimonious series of negotiations between the United States and Japan.

The Code which came into effect in January 1981 is designed to allow access by signatory nations to each other's lucrative government procurement markets. During 1979 and 1980, the United States felt that it had achieved the appropriate reciprocal balance under the proposed code with all countries except for Japan. The problem was that Japan's Government does not have a central agency which buys in amounts sufficiently large to bring most purchases by individual ministries under the code. The United States, therefore, insisted that the procurement of telecommunications equipment by the quasi-governmental Nippon Telegraph and Telephone Public Corporation (NTT) be opened to U.S. suppliers.

The position of the United States was that (1) reciprocity in terms of commercial opportunities could not be achieved without the addition of NTT; (2) that U.S. telecommunications equipment is highly competitive and technologically advanced, so the "buy Japanese" policy of NTT unfairly discriminated against U.S. exports; and (3) that since the bulk of the U.S. telecommunications industry is private and open to Japanese suppliers, that U.S. producers should have the opportunity likewise to sell in Japan.[27]

Many U.S. business executives viewed NTT as a symbol of general Japanese protectionism of key industrial sectors. Many Japanese saw the issue as U.S. "bullying" of Japan, because comparable demands were not made of European nations.[28]

If no acceptable compromise had been reached by December 31, 1980, the Trade Agreements Act of 1979 [29] required that Japan be barred from virtually all U.S. Government contracts. Japan eventually agreed to open approximately $3.3 billion in NTT purchases to U.S. firms.[30] Because of this compromise (along with the tobacco agreement discussed below). U.S.-Japan relations ended 1980 on a positive note.

The NTT negotiations illustrate that the Japanese Government is willing to concede to strong U.S. demands in spite of objections from vested interests even if such concessions adversely affect industries central to Japan's economic development strategies. Because such concessions are agreed to by consensus, however, the necessity for working out a suitable compromise must be obvious even to Japanese hardliners. This seems to require a U.S. negotiating posture that is tough and tenacious combined with both positive and negative bargaining chips.

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[27] U.S. Congress. House Committee on Ways and Means. "Trade with Japan." Hearings, 96th Congress, 2d session, Aug. 26, Sept. 18, 1980. Washington, U.S. Government Printing Office, 1980. pp. 205–207.

[28] Urban C. Lehner. "Japan to Open Phone Contracts to U.S. Firms." The Wall Street Journal. Dec. 8, 1980. p. 32.

[29] Public Law 96–39, July 26, 1979, section 302.

[30] "U.S. and Japan Set Key Trade Accord on Phone Contracts." Wall Street Journal, Dec. 19, 1980, p. 28.

A criticism by U.S. industry of certain past negotiations is that with the U.S. commitment to open trade, the United States tends to send mixed signals to Japan. This diversity of policy positions by different U.S. Government spokesmen tends to preclude a consensus from forming in Japan.[31]

U.S. Agricultural Exports

Japan is the single most important market for U.S. agricultural exports.[32] In 1980, Japan bought $5.1 billion worth of food, feeds, and beverages in addition to another $2.1 billion worth of soybeans, unmanufactured cotton, tobacco, and animal skins from the United States. Japan imports about half of its food requirements, and demand is growing rapidly.

Unlike Japan's policy to eliminate gradually most protection of its industrial sector, protection of Japan's agricultural sector remains intact. While similar protection is common among most countries, Japan's seems somewhat extreme. In 1979, food cost 70 percent more in Tokyo than it did in New York City or Paris.[33]

The justification behind these restrictive policies lies in a triad of problems faced by the Japanese Government.

Japan's fundamental problem harkens back to its basic food insecurity. High import dependence and memories of empty stomachs during and immediately following World War II linger in the minds of policymakers. Periodic world shortages of specific commodities have intensified this insecurity. With the U.S. nuclear umbrella insuring Japan's military integrity, food security has become an important national policy goal.

This focus on the security of food supplies has resulted in two policy thrusts by the Japanese Government, both disruptive of international trade. One is the drive to develop world-class export industries that can generate the foreign exchange necessary to pay for food imports. The other is an attempt to achieve as much food self-sufficiency as possible. Japan's basic agricultural policy has been to emphasize domestic food production, even if that production is uneconomic and high cost.

The second problem in the triad of Japan's agricultural anxieties is political. The pro-American Liberal Democratic Party, which is now in danger of losing the parliamentary majority that it has maintained throughout most of the postwar period, relies heavily on the farm vote, which seems to wield a disproportionately large amount of political power. Much of this power stems from Japan's unwillingness to redefine voting districts despite large population shifts from rural to urban areas.

Within Japan's central government, moreover, the Ministry of Agriculture dominates the other ministries in setting food policy. Even the powerful industrialists whose interests lie in reducing the cost of food to workers in the industrial and export sector have not been notably successful in countering the protectionist policies of the agricultural ministry.[34]

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[31] A criticism of the administration's position opposed to automobile import restrictions during congressional hearings in 1980 was that it lessened the incentive for Japan to make any concessions.

[32] Horsely, Beverly. U.S. Agriculture Still Bullish on Japan—Exports There Exceed $5 billion. Foreign Agriculture, v. 17, November 1979, pp. 10–12.

[33] Gutman, M. and A. Kruck. Prices and Earnings Around the Globe, 1979/80 edition. Zurich, Union Bank of Switzerland, 1979, p. 11.

[34] Brown, Owen. Industrial Japan. "Foods, If it Wiggles on the Way Down, It's Fresh." Far Eastern Economic Review, v. 110, Dec. 5, 1980, pp. 80–81.

Japan's third problem in agriculture lies in the system of price supports designed to maintain agricultural incomes. Instead of relying on a program of deficiency payments or direct cash subsidies to farmers, the Government actually buys major staple foods directly from the farmer and then resells them to wholesalers. This system has resulted in prices being determined more through a political than economic process. The Government's purchase price for rice, for example, is more than three times the world price. A key to minimizing government payments under such a system is to rigidly control imports. Otherwise budgetary requirements to maintain such a system would climb beyond the $4 billion allocated in 1979.[35] A recent report that cans of American-made, tomato and rice soup had been denied entry into Japan because they contained rice (a controlled commodity) illustrates how closely trade in these commodities is monitored.[36]

Japanese price supports for rice are so high that Japan has recently been faced with the problem of disposing of a huge rice surplus. Much of the excess rice has been grown on land ill-suited to rice cultivation and has displaced production of vegetables and other crops.[37]

High quality beef and citrus products are two specific agricultural commodities which have been the object of recent negotiations between the United States and Japan. Japan controls both products by rigid import quotas, during the Tokyo Round of the Multilateral Trade Negotiations, Japan agreed to a 14,000 metric ton increase in its quota for high quality beef to 30,800 metric tons in 1983. Japan also intends to increase the quota for citrus to 94,500 metric tons (fresh oranges and orange juice) by 1983. Even with these increases, however, the quotas remain highly restrictive.[38]

Even though a considerable liberalization of trade in beef and citrus products would have little impact on the bilateral trade imbalance with Japan, these items symbolize the complaints many U.S. exporters voice against Japanese import policies. In agricultural exports, the United States clearly has a competitive advantage and produces a high quality product. Yet U.S. exports in those key, sensitive areas are rigidly restricted.

Congress will continue to play an important role in the oversight and support of the Administration's negotiating efforts in liberalizing Japan's agricultural import sector. Congress, however, could also assist the Japanese Government in placing its agricultural policy on a more rational basis by allaying some of the basic Japanese fears over the insufficiency of food imports. The House Ways and Means Committee has suggested two actions that could be taken. One would be to insure that there is no repeat of a food embargo like that on soybean exports to Japan which occurred during the Nixon Administration.

The second would be to provide Japan with long-term guarantees on U.S. food exports similar to those negotiated with the Soviet Union and the People's Republic of China. The U.S. pledge made in December 1980 to provide 22.5 million tons of grains in 1981 was a positive first step in this direction.[39] Such actions would enhance Japan's con-

[35] Bank of Japan. Economic Statistics Annual, 1979, p. 212.
[36] Tunney, John V. "Looking for a Balanced Framework in U.S.-Japan Trade." Los Angeles Times. Jan. 7, 1979, pp. IV–2, IV–6.
[37] The United States and Japan reached an agreement in 1980 on the orderly disposal of surplus Japanese rice on world markets. Japanese sales had been undercutting U.S. rice exports in Asian markets.
[38] House Ways and Means Committee, U.S.-Japan Trade, op. cit., p. 56.
[39] Cullison, A. E. "U.S. Grain Pledge Assuages Japanese." Journal of Commerce, Dec. 12, 1980, pp. 1, 7.

fidence in the long-term stability of food supplies. Unless such underlying problems are solved, further Japanese concessions in agricultural imports are likely to come mainly at the expense of considerable goodwill and only through intense bargaining effort.

Tobacco Products

Japan's restrictions on sales of imported cigarettes, cigars, and pipe tobacco typify some peculiar institutional barriers that can be encountered when selling in Japan.

All aspects of tobacco manufacture and sales in Japan are controlled by the government's Tobacco and Salt Monopoly. This monopoly imports both finished products and tobacco leaf which it then manufactures into cigarettes. Like any monopoly, it has attempted to curtail competition (all foreign) by restricting the number of outlets authorized to sell imported tobacco products, setting prices for imported brands at about 110 to 140 yen more than domestic brands, and banning advertising of imported products. Since 1978, the United States has been protesting the restrictive policies of the monopoly as a nontariff barrier to U.S. exports.

The Japanese Diet (legislature) responded by converting the monopoly's pricing policies into equally restrictive tariffs which became effective April 1, 1980. These tariffs actually increased the price differential between Japanese and U.S. cigarettes.

On November 21, 1980, however, some two years after tobacco became an issue, Japan agreed to reduce tobacco tariffs from 90 to 35 percent on cigarettes, 60 to 35 percent on cigars, and 110 to 60 percent on pipe tobacco. Profit margins on sales of imported cigarettes are to rise to equal those of domestic; the number of authorized retailers selling foreign tobacco products is to increase in 1981 from 14,000 to 20,000, and U.S. companies are to be permitted to advertise. As a result, U.S. tobacco sales in Japan are expected to rise from $35 million to about $350 million annually.[40]

The tobacco issue illustrates Japan's import-substitution strategy for economic development. Even in industries where foreign manufacturer might be more efficient, Japan generally prefers to import only the raw materials and perform domestically as much of the value-added work as possible. Other examples of this strategy are the Japanese preference for importing logs instead of lumber and raw hides instead of leather products.

The tobacco problem also illustrates how institutional factors and governmental pricing policies can discriminate against imports. It also shows, however, that Japan is willing to make sizeable concessions, although those concession might be computed from a starting point that is so restrictive that the end result is far from a free trade solution.

The tobacco trade also shows that even though Japan's labor costs are generally lower than those in the United States, the Japanese tendency to retain surplus labor, especially in quasi-governmental institutions, can make U.S. products quite competitive in Japanese markets. U.S. consumer goods, moreover, because of past protectionist policies are often considered luxury items. They, therefore, face some pent-up demand, which can be exploited if restrictions are eliminated.

[40] Seaberry, Jane. "Japan Lifts Import Duties on Tobacco." Washington Post, Nov. 22, 1980, p. C1.

Product Approval Procedures and Standards

The Agreement on Technical Barriers to Trade negotiated under the Tokyo Round of the Multilateral Trade Negotiations brought to public attention many of the import-restricting standards and product approval procedures practiced by countries. Those in Japan were no exception. As Japan brings its practices into conformity with the requirements of this standards code, however, many of these problems should diminish.

The dampening effect on U.S. exports caused by safety and health standards in Japan has been documented by many "horror stories" among U.S. firms. The major problems have been (1) product approval requirements generally oriented toward design rather than performance characteristics; (2) difficulty in obtaining information on specific standards and inspection procedures to be applied; (3) excluding foreign manufacturers from deliberations on establishing and promulgating standards; (4) requiring that approval be obtained through a resident company; (5) requiring U.S. firms to release proprietary information; and (6) the general mandate that all testing (except for automobiles) and approval occur in Japan.[41]

Over the past three years much progress has been made in overcoming these problems. Part of the credit can go to the U.S.-Japan Trade Facilitation Committee (TFC) whose U.S. offices are housed in the Department of Commerce and the U.S.-Japan Trade Study Group (TSG), a group of American and Japanese volunteers from both business and government who meet in Tokyo. Both organizations have been instrumental in bringing the problems to light and seeking acceptable solutions.[42]

As of December 1980, Americans had filed 93 complaints against Japan with the U.S. side of the TFC. Of this total, 31 were dropped after preliminary review by the Washington TFC staff, and 61 were forwarded to the U.S. Embassy in Tokyo (1 case was in progress). The Embassy, in turn, transmitted 22 for action by the Japanese side of the TFC. Of these, 16 have been favorably resolved, 1 has been withdrawn (not resolved), and 5 are in progress.[43]

Two interesting points emerge from the TFC case figures. First, only 22 of 92 complaints (24 percent) were sufficiently serious from a U.S. point of view to justify forwarding to the Japanese side for action. Second, of the 22 cases actually presented for action, the vast majority have been or apparently will be resolved favorably.

Problems still remain, however, in products such as cosmetics, medical equipment, and automobiles where it is claimed that standards and inspection requirements continue to impede U.S. sales. The approval process in Japan also seems excessively slow. Because it requires extensive documentation, U.S. exporters suspect that the Japanese Government is actually stalling in order to allow domestic manufacturers time to bring competing products on line.[44] Until full reciprocity is achieved

[41] Weil, Frank A. and Norman D. Glick. "Japan—Is the Market Open? A View of the Japanese Market Drawn from Corporate Experience." Law and Policy in International Business, v. 11, 1979, pp. 868–869

[42] Ibid., p. 868–879. U.S.-Japan Trade Study Group. A Special Progress Report, April 1980 (mimeographed), pp. 1–17. The Japan-United States Economic Relations Group (Wisemen) has also been instrumental in solving bilateral trade problems.

[43] Joint U.S.-Japan Trade Facilitation Committee. "Status of TFC Cases, Typed Report," Dec. 11, 1980.

[44] Interview by author with an American corporate lawyer in Japan, Tokyo, March 1979.

in standards and approval procedures, Congressional support of efforts by the TFC and TSG as well as by the Administration and other groups will be important.

Other Bilateral Issues

Trade friction between the United States and Japan has also arisen over computer timesharing services, banking, fishery products, forest products, hides and leather, civil aviation, and aluminum.

In computer timesharing services and banking, complaints of unequal treatment by U.S. firms in Japan appear to have been favorably resolved. The unresolved issues in fishery products are high Japanese tariffs and the rights of Japanese fishermen to harvest catches in U.S. territorial waters. If Japan is excluded from fishing in U.S. waters, possible adverse repercussions in terms of U.S. fishery exports to Japan could occur, and Japan might seek alternative sources of supply.[45]

In forest products, U.S. export controls on logs as well as both the Japanese unwillingness to buy lumber instead of logs and general U.S. unwillingness to cut lumber to Japanese specifications remain unresolved.

The hides and leather issue touches on a social problem in Japan. Traditionally anyone in an occupation associated with death (undertakers, butchers, tanners, etc.) was considered to be an outcast, even though racially he might be indistinguishable from the rest of the Japanese population. Despite considerable efforts by the Japanese Government to eliminate this discrimination, it continues today. Unfortunately, virtually all of the leather workers in Japan are from this outcast society. Displacing their work with imports would cause severe social disruption. Hence, imports of leather and leather goods are restricted by both a 20 percent tariff and import quota.

The United States, however, has succeeded in negotiating an increase in its quota for leader imports to Japan amounting to two percent of the market. Despite this quota increase, however, from April 1979 through March, 1980, U.S. leather exports had not even reached the quota level. This was partly attributable to high U.S. prices, but lower U.S. quality and the need for more individualized shipments were also important. As a House Ways and Means Committee report recently concluded, ". . . the United States cannot assume that American goods will automatically be purchased as quotas are increased. Quality and price competition must also be met." [46]

Conflict between the United States and Japan is also mounting over the existing Civil Aviation Agreement between the two countries. Japan maintains that the existing bilateral agreement favors the United States and is seeking to revise it. The United States, however, is seeking greater deregulation of international airlines, more control over prices, and more access by charters to Japan. It is hesitant, therefore, to revise the agreement in a manner that would give Japan more power to control the number of inward flights by U.S. carriers.[47]

[45] House Ways and Means Committee, U.S.-Japan Trade, op. cit., pp. 58–59.
[46] House Ways and Means, U.S.-Japan Trade, op. cit., p. 60.
[47] Furuyama, Mikio, "Conflict Between Japan and U.S. in Civil Aviation Field is Mounting." The Japan Economic Journal, Dec. 16, 1980, p. 15. Anita Schrodt, "U.S. Japan Remain Split on Air Accord." Journal of Commerce, May 29, 1981, p. 2A.

In aluminum, a surge of exports from the United States in 1980 has brought protests from Japanese producers who face energy costs considerably higher than their American counterparts.[48]

Yen-Dollar Exchange Rate

Under the current floating exchange rate system, relative currency values are ideally determined in an orderly manner according to the forces of supply and demand. The need for massive government intervention and sharp changes in currency values should diminish under such a system. Instead of infrequent large changes, the market is designed to continually float values up or down in small increments as economic conditions change.

As shown in Table 3, however, the average annual exchange rate has fluctuated widely between as much as 303 to as little as 211 with a low of 190 yen per dollar in the fourth quarter of 1978.

TABLE 3.—*Yen-dollar exchange rate, 1972–June 1981*

Year:	*Rate*
1972	303
1973	271
1974	291
1975	292
1976	297
1977	269
1978	211
1979	219
1980	227
1981 (June)	224

Source: International Monetary Fund. International Financial Statistics.

Such large swings in relative exchange rates can negate gains in tariff concessions and change relative costs of production faster than investment in new plant and equipment can occur to account for the changes. Between January 1979 and April 1980, for example, the 25 percent appreciation of the dollar potentially raised U.S. car prices in Japan by more than the commodity tax on large cars of 22.5 percent that often has been blamed for the high prices of U.S. cars there. Likewise, the appreciation of the yen in 1978, forced Japanese automakers to raise prices on their cars by more than those of U.S. producers, which reduced sales of Japanese cars in the United States considerably.

These yen-dollar fluctuations, when they are excessive, alter competitive positions and can add to tensions as well as trade balance problems between the two countries. The strength of the U.S. dollar in 1980 and 1981, moreover, contributed greatly to the current bilateral trade deficit with Japan.

Defense Expenditures

One common criticism of Japan is that it has developed its export sector through investment of funds saved because of Japan's low level of defense expenditures. The implication is that Japan has been given a "free ride" in national defense by the United States' guarantee of its security, and it has used the funds saved in defense expenditures to compete in American markets.

[48] "Japanese Aluminum Producers Blast 'Unfair' U.S. Competition." Journal of Commerce, Apr. 19, 1981, p. 13A.

The defense issue is outside the scope of this essay, but a short summary is in order. Although the "no-war" clause in Japan's U.S.-imposed constitution prohibits the maintenance of armed forces, Japan has circumvented this requirement by focusing on forces for self defense. Traditionally, defense expenditures have been kept to less than one percent of gross national product. With the rapid growth of the Japanese economy, however, these expenditures have increased to where Japan now ranks eighth in the world in terms of military funding. The bulk of defense spending in Japan, however, goes for manpower. While a consensus is forming among many groups in Japan that the country must begin to provide for more of its own defense, the pacifist constitution and Japan's budgetary constraints do not augur well for large increases in defense spending in the near future.

Japan's Competitive Challenge

A real danger in dealing with U.S.-Japan trade relations is that the focus on finding solutions to the problems of the present can dim one's view to more pressing problems of the future. A spokesman for the U.S. automobile industry once remarked that if you see a light at the end of the tunnel, it is probably a train coming through. This could characterize the competitive challenge from Japan. While an approach of "stomping out brushfires," or solving individual problems as they arise might be both necessary and effective in the short term, it might not address longer-term, and perhaps more serious, problems.

U.S. industries such as iron and steel, television receivers, and household appliances appear to be adjusting to Japanse competition. Other industries such as semiconductors, computers, telecommunications equipment, aircraft parts, and machine tools, however, are bracing themselves for severe competition in the 1980s. These are the high technology industries that base their competitiveness more on innovation and research than on lower labor costs or productivity differences. They also are the industries in which the United States traditionally has received only few serious challenges from abroad but in which Japan hopes to excel during the 1980s.[49]

A recent study of U.S. competitiveness by the U.S. Department of Labor concludes that since the late 1960's, the United States has suffered a decline (in some cases only relative) in its competitive position, primarily in consumer goods and automobiles. The study expresses concern over the lagging U.S. rate of industrial capital expansion, the relative decline in expenditures for research and development in the U.S. as measured by their percent of gross national product, the lagging rate of growth of productivity in manufacturing, and the foreign barriers to sales of U.S. exports.[50] Similar conclusions were reached by a European study.[51]

The solutions currently being proposed to these problems generally fall under programs for re-industrialization or supply side economics. These call for a restructuring of incentives in the U.S. economy to

[49] Japan Ministry of International Trade and Industry. "The Vision of MITI Policies in 1980s." Summary (provisional translation). Mar. 17, 1980. mimeograph. pp. 14–17.

[50] U.S. Department of Labor. Office of Foreign Economic Research. Report of the President on U.S. Competitiveness together with the study on U.S. competitiveness. Washington, U.S. Government Printing Office. 1980.

[51] Dreyer, Peter H. "U.S. Held More Competitive Than West European Nations." Journal of Commerce, Dec. 2, 1980, p. 10.

channel more resources into technological development and strengthening the productive capacity of U.S. industry.[52] Such actions could enhance the ability of certain U.S. industries to meet Japan's competitive challenge rather than attempt to limit it through import restrictions.

The push for supply-side efficiencies in the United States, however, generally skirts the issue of high U.S. wages in certain industries. In the past, higher U.S. labor productivity often offset higher U.S. wages, with the result that labor costs per unit of output for many products were not exceptionally high. With the growth in labor productivity in the United States falling far below that in other major countries, however, unit labor costs have been rising more rapidly in the United States than in Japan. Between 1975 and 1979, for example, unit labor costs rose by some 30 percent in the United States compared to virtually no change in Japan.[53]

Dollar depreciation, of course, offsets the rising unit labor costs in the United States somewhat, but the underlying trend is disturbing. In manufacturing, U.S. wages are climbing faster, while U.S. productivity is rising more slowly than in Japan. Unless this situation is reversed, either the dollar will have to be allowed to depreciate further against the yen or the United States could find itself with low-productivity and high-wage industries that will face severe competition from Japan. During 1981, the steady strengthening of the U.S. dollar relative to the yen indicates that Japan's exports are likely to become even more price competitive in the U.S. market.

Summary

U.S.-Japan economic relations seem paradoxical. On one hand, the disagreements between the two countries are perhaps stronger now than at any time in the postwar period. On the other hand, the procedures for resolving disputes and the willingness of both sides to compromise in order to reach amicable solutions appear firmer now than at any time in history.

As the world's two largest economies in the non-communist world, the United States and Japan find common ground in economic systems based primarily on market principles and political systems based on democracy. The United States is Japan's largest export market, while Japan trails only Canada as a market for U.S. products.

U.S. exports to Japan consist primarily of agricultural products, industrial supplies and materials, and capital goods. Japan's exports to the United States are comprised mainly of automobiles, consumer durables, and capital goods.

Over the 1975–80 period, the United States incurred a cumulative merchandise trade deficit with Japan of $45.6 billion. Although this deficit with Japan is offset largely by a surplus with Western Europe, it has become a major friction point and is viewed by some as a primary cause of the erosion of good will and support of trade in the United States. The bilateral trade deficit, which is expected to reach record levels in 1981, is certain to heighten tensions between

[52] Etzioni, Amitai. "Re-industrialize, Revitalize, or What?" National Journal, v. 43, of Commerce, Dec. 2, 1980, p. 10

[53] U.S. Bureau of Labor Statistics and Japan Productivity Center. See also Alfred L. Malabre, Jr. "Factory Labor Costs Soar in the U.S. But Hardly Budge in Japan." The Wall Street Journal, Oct. 15, 1980, p. 52.

the two countries. An effective method to reduce the deficit would be for Japan to adopt expansionary economic policies. Such measures are constrained, however, by a huge Japanese government budgetary deficit of $55 billion in 1981, equivalent to about 5 percent of GNP.

Problems in the U.S.-Japan economic relationship are based primarily on three factors. The first is the changing relative economic strengths of the two countries. The quarter century of rapid economic growth and development in Japan following postwar reconstruction has brought many Japanese industries to the point where they are as efficient or even more efficient than their American counterparts. Japanese industries also have developed methods for quality control and product design that are highly effective. Japan's competitive challenge is one of the most serious problems facing U.S. industry today.

The second factor is the rising price and unstable supplies of petroleum and food in world markets. The soaring import bills for oil and food have forced Japan to develop highly competitive export industries in order to generate the foreign exchange necessary to pay for them. Japan's large trade deficit in energy and food (as well as other raw materials), requires a surplus in trade in manufactured goods. For nearly five years now, much of that surplus has been generated in U.S.-Japan trade. The instability of food supplies has also forced Japan to attempt to produce more of its food from small, domestic farms, which can compete with imports only with the aid of highly protectionist devices.

The third underlying factor is that the United States and Japan are negotiating from two widely different historical positions in terms of protection of domestic economies. After the restrictive Smoot-Hawley Tariff of 1929, the United States has been a world leader in reducing barriers to international trade. Japan, in contrast, has spent most of its modern history jumping from one balance-of-payments crisis to another. Only recently has Japan developed the strong export industries that have enabled it to generate large surpluses in merchandise trade.

When the degree of protection, in particular nontariff or institutional protection is compared between the two countries, therefore, Japan appears much more protectionist than the United States. In terms of recent changes, however, Japan has been making large concessions and is adapting to a more open economy. These changes, however, take time and, meanwhile, leave Japan open to criticism from abroad.

Specific bilateral trade problems include Japanese exports of motor vehicles and other high technology products to the United States as well as U.S. access to Japanese markets in automobiles, telecommunications equipment, tobacco products, beef, citrus and many other products.

In automobiles, Japan's announcement in May 1981 of voluntary export restraints has calmed the debate over the issue, but loopholes in the restraints could allow Japanese automakers to continue to exert competitive pressures on U.S. producers. The restraints also are not expected to induce any large recall of U.S. autoworkers. Other unresolved issues include barriers to sales of U.S. automobiles in Japan and the 1980 reclassification of imported pickup trucks from Japan that changed their import duty from 4 to 25 percent.

In U.S. sales of telecommunications equipment to Japan, after several years of somewhat acrimonious negotiations, Japan agreed to open approximately $3.3 billion in purchases by its telephone company to U.S. firms.

Although Japan is the largest buyer of U.S. agricultural exports, serious barriers to U.S. exports of wheat, beef, and citrus products remain. Because of Japan's basic food insecurity, the political power of its farm vote, and budgetary constraints, Japan's agricultural sector continues to receive considerable protection from import competition.

Recent Japanese concessions in imports of tobacco and leather promise to expand U.S. exports there.

Specific problems with U.S. exports to Japan are being solved by the Trade Facilitation Committee within the U.S. Department of Commerce.

In general, problems remain in the U.S.-Japan economic relationship, but the strong interest on both sides in reaching satisfactory solutions as well as the existence of institutional mechanisms to solve those problems augur well for the future of the relationship.

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FOREIGN DIRECT INVESTMENT

By Dorothy Christelow*

Overview

During the past decade, there have been important changes in international direct investment flows and in the United States role in those investments:

In real terms, the growth of international direct investment slowed considerably, from 9 percent per annum in the 1960's to little more than 5 percent in the 1970's. But it remained far healthier than the growth of domestic investment in the industrial countries, the main source of capital, thus suggesting increasing internationalization of business investment.

The contribution of the United States to total international investment in the world's market economies fell from around two thirds in the 1960's to less than half in the latter half of the 1970's while its share of inward direct investment flows doubled to over 20 percent. The shares going to newly industrialized countries (NIC's) also increase very substantially while the share going to OPEC countries and to other industrial and less developed countries declined irregularly.[1]

These developments were in good part a reflection of broad trends in the world economy. The slowing of real international investment was related to decelerating real growth and hence capacity to invest of the industrial countries. The declining role of the United States as a source of international investment reflected the cumulative effect of relatively stronger growth of productivity and output in other industrial countries over the past two decades. The importance of the United States as a host to foreign investment was enhanced by dollar depreciation during much of the decade, which lowered the prices of U.S. assets to foreigners. More recently, depressed U.S. stock prices in response to exceptionally high interest rates attracted foreign as well as domestic takeover bids for U.S. firms. Moreover, the rising price of raw materials relative to manufacturers attracted investment to the United States and other resource-rich areas. Finally, the shift to export promotion created new profit opportunities in a number of newly industrializing countries thus attracting investment.

The volume and direction of international direct investment has also been influenced by changes in national investment policies. In home-country policies, the most important influence was probably Japan's active encouragement of outward investment in resource industries, to ensure access to raw materials, and in manufacturing in

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[1] In this paper no account is taken of international direct investment flows into or out of the COMECON countries and the People's Republic of China.

low-wage countries to help Japanese firms meet rising foreign competition.

Changes in host-country policies tended to boost investments in manufactures but to restrain investments in resources. On the one hand, most countries subsidized inward investment in new manufacturing industries. Industrial countries also subsidized such investment in declining areas in order to sustain employment. Some of the subsidized investments may have improved world productivity and output in the long run; but others probably misallocated resources and proved costly to the countries granting the subsidies.

On the other hand, as the foreign influence increased, more attention was given to the negative aspects of foreign investment especially the difficulties of regulating multinational firms and their possible depressing effect on domestic enterprise. Those considerations led to insistence on local participation, discouragement of investment in areas where foreign influence was already strong, and government takeovers. Such policies were most widely pursued in resource industries, for example in OPEC countries and in Canada, and greatly reduced foreign investment in those areas.

United States policy on international direct investment was close to neutral from 1974 until 1980. The government has also worked with international organizations to develop liberal codes on direct investment, opposing competitive subsidies of inward investment and discriminatory treatment of foreign firms.

Recently, however, our national policies on inward investment have shown signs of becoming more interventionist. This is partly because foreign investment inflows continue to outpace our investment abroad and partly in reaction to Canada's increasingly discriminatory treatment of U.S. firms.

The growing U.S. role as host to foreign direct investment and the policy conflicts that it has generated should deepen this country's understanding of host-country problems. It could also enhance the U.S. bargaining position in negotiating international investment codes which would minimize intervention while recognizing national interests.

I. Recent Trends in International Direct Investment

International direct investment differs from other international capital flows in that the investor has or acquires an equity interest in the enterprise receiving the funds sufficient to provide an important voice in company management. In the United States, the line between direct investment and portfolio investments (where no voice in management is involved) is set at 10 percent foreign equity holding.

Historically, companies making investments abroad, especially U.S. companies, have preferred 100 percent ownership or strong majority holdings, acquired either by takeover or by establishing a new wholly-owned subsidiary. But for affiliates established in the 1970's, there has been a distinct trend away from 100 percent ownership.[2] This is partly a matter of necessity since many of the countries in the develop-

[2] This trend is evident in sample data supplied by Harvard Multinational Enterprise Project and reported in "Transnational Corporations in World Development: A Reexamination," United Nations, 1978.

ing world, to which much new investment has been directed, require local participation. Recently, however, some investors have chosen joint ventures with host country partners—either to spread the risk or to improve the firm's adjustment to a foreign cultural and regulatory environment—even when this was not required by law.

The initial acquisition of an equity position is subsequently supplemented by other related transactions that are also classified as direct investment: reinvestment of earnings, and loan transactions between the company in question and its foreign affiliates. A further distinguishing characteristic of international direct investment is that the capital invested is accompanied by a bundle of managerial skills and, in many cases, technologies that are advanced relative to those previously available in the host country.

Business firms making direct investments abroad are commonly those producing for both domestic and export markets and possessing technological, managerial or financial advantages over firms in host countries. Foreign investment may be motivated by an interest in developing natural resources located abroad or by the need to develop a foreign distribution network for exports from the home country. In the case of manufactures, the decision to invest abroad may be triggered by actual or potential competition from producers in other countries with lower labor or raw materials costs, by foreign tariff barriers to exports, or by other foreign inducements to investment.[3]

It may be estimated that the book value of all international direct investment outstanding is now approaching $400 billion.[4] As indicated in Table I, between one-third and one-half of the major investing

TABLE I.—INDUSTRY DISTRIBUTION OF THE INTERNATIONAL DIRECT INVESTMENT ABROAD BY MAJOR INVESTOR COUNTRIES

[Percent of home country direct investment]

	United States, outstanding end-1978	United Kingdom, outstanding end-1978	Germany, outstanding end-1977	Japan, flows 1973–78	France, flows 1973–77	Canada, outstanding end-1976
Mining	4.2	4.5	4.6	20.6	(1)	18.4
Petroleum	19.8	(2)			36.1	
Manufacturing	44.1	59.4	41.1	37.0	32.2	51.3
Commerce	10.5	16.6	19.1	15.1	14.5	3.6
Finance	14.3	(1)	[4] 14.6	27.3	8.6	26.7
Real estate	7.1	3.1	20.6		3.1	
Other		16.4			5.5	
Total	100.0	100.0	100.0	100.0	100.0	100.0

[1] Not reported separately.
[2] Excluded.
[3] All energy sources.
[4] Includes some real estate and housing enterprises.

Sources:
United States: U.S. Department of Commerce, "Survey of Current Business," August 1979, part I.
United Kingdom: Department of Trade, Trade and Industry, Feb. 25, 1977.
Germany: Deutsche Bundesbank, "Monthly Report," April 1980.
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Canada: Statistics Canada, "Canada's International Investment Position," 1976, Cat. 67202, May 1980.

[3] For some useful recent contributions to the vast literature on the theory of why international direct investment occurs, see: J. H. Dunning, "Explaining Changing Patterns of International Production: In Defense of an Eclectic Theory" and R. Vernon, "The Product Cycle Hypothesis in a new International Environment" in Oxford Bulletin of Economics and Statistics, November 1979.

[4] Based on estimates of total investment in 1976 made by U.N. Centre on Transnational Corporations, recorded direct investment flows in 1977 and 1978, and rough estimates for 1979 and 1980.

countries' holdings is in manufacturing. In that sector, investments of U.S. and German firms tend to be concentrated in high-technology industries such as chemicals, engineering products and transport equipment. By contrast, the United Kingdom and Japan have in the past placed more emphasis on less technology-intensive sectors such as food, drink and tobacco, textiles and clothing and (in Japan's case) primary and fabricated metals.[5] Investments in petroleum are important for firms based in the United States, the United Kingdom, the Netherlands and France. Trade absorbs between 10 and 20 percent of most countries' investment. Finance attracts between 9 and 15 percent of the major countries total investment.[6]

Stock figures, large as they may seem, underestimate the importance of foreign-owned firms in national economies since foreign equity is only a fraction of the total assets and liabilities of such firms. Other sources of finance include: borrowing from banks, security issues, trade credits from unaffiliated suppliers and the equity position of host country residents. Comprehensive surveys of foreign-controlled firms in the U.S. and Germany made during the 1970's show the ratios of foreign equity to those firms' total assets or liabilities to have been 15 percent in the U.S. and 27 percent in Germany.[7]

One gauge of the importance of foreign-controlled firms is their share of total sales in their host economies. Table II groups host countries according to foreign controlled companies' share of sales in the manufactures sector. In the major European countries and a number of newly industrializing countries the share of foreign-controlled firms is in the vicinity of 20 percent. But for many other countries—including Canada, Australia, New Zealand, South Africa, Peru, Brazil, and Argentina—the share ranges up to 50 percent or even more. For the United States, Japan and a few others the ratio is well under 10 percent.

The annual growth of world wide international direct investment flows, valued in dollars, held in the 12–13 percent range in the 1960's and 1970's.[8] But taking into account the acceleration of world wide inflation during the 1970's, it is clear that the real growth of direct investment slowed considerably in the past decade. Deflating by an index of the dollar price of plant and equipment in the major investor countries produces the estimate given in Table III, that real direct investment growth dropped from about 9 percent a year in the 1960's to 5 percent in 1970–78. Most of this slowdown was in direct investment flows among industrial countries while real investment in the developing world was well sustained.

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[5] Dunning, op. cit

[6] The United Kingdom does not report direct investment in petroleum or finance (apparently due to difficulties in defining direct investment in those industries) but the amounts invested in those industries are known to be large.

[7] Foreign Direct Investment in the United States, vol. 2, United States Department of Commerce, April 1976; and Monthly Report of the Deutsche Bundesbank, April 1978.

[8] The most comprehensive source of information on world-wide international direct investment is the compilation of national statistics on outward and inward flows published by the International Monetary Fund (IMF) in its Balance of Payments Yearbook. A second excellent source is the OECD compilation of direct investment flows from its members (which accounts for 98 percent of all recorded outflows) to the developing countries. In both cases countries contributing data attempt to follow the accounting procedures established by the IMF. However, they are not always able to provide complete information on all items. Thus statistics on both outward and inward flows are incomplete. Since U.S. statistics on international direct investment are more comprehensive than those provided by some other countries, the role of the U.S. world-wide direct investment flows tends to be overstated. Further, since the U.S. role in outward investment is greater than its role in inward investment, a world-wide aggregation of direct investment outflows always produces a substantially larger total than an aggregation of direct investment inflows.

Further details on the international distribution of direct investment flows are given in Table IV. Although industrial countries remained virtually the only source of supply, the U.S. contribution dropped steeply, while the largest gainers were Germany and Japan. Looking at direct investment inflows, the U.S. share doubled over the same period rising from 11 to 24 percent. But that of other industrial countries dropped so sharply that the share of industrial countries as a whole declined. The gainers among the less developed countries were mainly the group known as newly industrializing countries (the NIC's), such as Brazil and Korea, whose share rose from 10 to 16 percent. The investment share going to OPEC countries turned negative in the early 1970's but surged to a positive 9 percent in the second half of the decade. Investment in other LDC's declined in the period surveyed.

TABLE II.—FOREIGN-OWNED FIRMS SHARE IN MANUFACTURES IN SELECTED COUNTRIES

[Percent of sales]

0 to 10	11 to 25	26 to 40	Over 40
United States (5).[1, 2]	Hong Kong (11).[3]	Mexico (27).	South Africa (40).[2]
Japan (5).	Spain (11).	Argentina (31).	Turkey (41).
Finland (5).	Korea (11).	New Zealand (33).	Peru (46).
Thailand (9).[3]	Denmark (11).[4]	Belgium (33).	Ghana (50).[5]
Sweden (10).	India (13).	Australia (36).	Malaysia (50).
	United Kingdom (19).	Brazil (37).[6]	Canada (58).[3]
	Norway (19).		
	Germany (19).[7]		
	France (23).[3]		
	Austria (23).		

[1] Percent of gross product in industrial sector.
[2] Includes extractive industries.
[3] Percent of employment.
[4] Excluding car assembly and oil refining.
[5] Assets of all commercial enterprises.
[6] Based on 5,113 largest nonfinancial enterprises.
[7] Manufacturing, mining, construction, and distribution.

Sources: For large industrial countries: collection of data from national sources as published in Christelow "National Policies Toward Foreign Direct Investment," Quarterly Review, winter 1978–80, Federal Reserve Bank of New York. The data (except for the United States) apply to various years in the 2d half of the 1970's. For other countries: "Transnational Corporations in World Development: A Re-examination," United Nations, 1978. The U.N. data relate to the situation in the 1st half of the 1970's.

TABLE III.—GROWTH OF INTERNATIONAL DIRECT INVESTMENT

[Annual rates of growth, percent]

	1962–70	1970–78
I. Total international direct investment:[2]		
Nominal	11.6	12.9
Real[3]	9.0	4.5
II. To developing countries:[4]		
Nominal	10.8	15.8
Real[3]	8.4	7.4
III. To industrial countries:[5]		
Nominal	11.8	11.5
Real[3]	9.3	3.1

[1] Straight line geometric trend.
[2] Sum of all countries' direct investment abroad, as reported in IMF, "Balance of Payments Yearbook."
[3] Nominal series deflated by GNP-deflator for gross fixed business investment in major investor countries.
[4] Sum of industrial countries' investment in developing countries as reported in OECD, "Investing in Developing Countries."
[5] Approximation. Underlying series derived by subtracting industrial countries investment in developing countries from total direct investment.

TABLE IV.—INTERNATIONAL DISTRIBUTION OF DIRECT INVESTMENT FLOWS

[Percent of total flows]

	1965–69	1970–74	1975–79
	Outward flows		
From:			
Industrial countries [1]	98.8	98.5	98.1
United States	66.7	51.6	49.0
United Kingdom	11.7	14.8	12.1
Germany	5.1	8.4	9.2
Japan	1.8	6.2	6.5
Netherlands	3.3	5.1	5.2
France	3.3	3.7	5.2
Canada	1.9	3.0	4.6
Other	5.0	5.7	6.3
Developing countries	1.2	1.5	1.9
	Inward flows		
To:			
Industrial countries [1]	70.2	70.3	67.4
United States	10.8	14.8	23.5
Other	59.4	55.5	43.9
Developing countries	29.8	29.7	32.6
Newly industrializing countries [2]	9.9	15.1	15.5
OPEC [3]	6.4	−3.6	4.8
Other	13.5	18.2	12.3

[1] United States, Canada, Japan, France, Germany, Italy, United Kingdom, Austria, Belgium, Denmark, Finland, Netherlands, Norway, Sweden, Switzerland, Australia, New Zealand.
[2] Brazil, Greece, Israel, Hong Kong, Korea, Mexico, Singapore, Spain, Taiwan.
[3] Algeria, Ecuador, Indonesia, Iran, Iraq, Libya, Nigeria, Saudi Arabia, Venezuela. Data for smaller OPEC members is unavailable.

Source: International Monetary Fund, "Balance of Payments Yearbook, Supplement."

II. World Economic Developments and Direct Investment Trends

International direct investment in the 1970's mirrored the main economic trends of the decade. That industrial countries should have remained the almost exclusive source of international direct investment is not surprising in view of their relatively greater wealth, industrial development, and thus ability to invest. In 1978, per capita gross national product averaged $8,070 in industrial countries as compared with $3,340 in the capital surplus oil exporting countries, $1,813 in the newly industrializing countries, $947 for other middle income LDC's, and $200 in low-income LDC's. With less than one quarter of the free-market world's population, industrial countries generated over three-quarters of its gross product.[9]

The notable slowdown in real international direct investment during the 1970's was no doubt due in part to the slowdown in real GNP growth in the industrial countries from about 5 percent in the 1960's to little more than 3 percent in the 1970's, and with it their capacity to invest either at home or abroad. In fact, the growth of industrial countries' gross domestic investment slowed from 5.6 percent in the 1960's to only 1.5 percent in 1970–78 while their real direct investment abroad held up much better, falling from 9 percent to 5 percent.

The rising importance of industrial countries other than the United States, especially Japan and Germany, as sources of international di-

[9] All of the statistics (except for those on direct investment) cited in this and the following two paragraphs are from World Development Report, 1980, World Bank, Washington, D.C. 1980.

rect investment was related to two developments. First, during the 1960's gross domestic product grew substantially faster in other industrial countries than in the United States, about 5½ per ent versus less than 4½ percent, as the technological and productivity lead that the United States had enjoyed earlier in the post-war period was narrowed and in some cases reversed. This trend, fueled in part by U.S. direct investment in those countries, in turn improved the capacity of other industrial countries to invest both at home and abroad. Second in the 1970's, as growth trends pulled closer together, the appreciation of the yen, the Deutschemark, and other-European currencies closely linked to the DM reduced the cost of foreign plant, equipment and labor for the countries concerned, thus increasing incentives to invest abroad.

The rising U.S. share of inward investment flows was also related to exchange rate changes since the dollar depreciated relative to the yen, the DM, and some related currencies during the 1970's. Other factors also operated to increase investments in the United States. Controls on the prices of petroleum and natural gas held down production costs in industries making extensive use of those materials relative to countries where world prices were paid, thus encouraging foreign investment in those industries. The rise in world prices of all raw materials relative to prices for manufactures encouraged investment in resource industries here. Tendencies toward protectionism in U.S. trade policies stimulated some foreign producers to substitute investment in manufacturing facilities in the United States for exporting to this country.[10] Finally, monetary restraint and exceptionally high interest rates in the United Statees during much of the past two years has depressed stock prices, increasing vulnerability of some U.S. firms to foreign as well as domestic takeovers.

Rising investment in the newly industrializing countries (NICs) was stimulated by a shift in those countries' overall development strategy from policies designed to foster import substitution to those aiming to expand exports.[11] This shift, which occurred in most of the NICs in the late 1960's opened up prospects for larger and more rapidly expanding markets for manufactures based in those countries, thus greatly encouraging foreign investment there. Investor expectations were amply fulfilled as the NIC's share in world industrial production rose from little more than 5 percent in the early 1960's to 9 percent in 1977 while their share of world exports of manufactures rose from less than 3 percent to 7 percent.[12]

III. NATIONAL POLICIES ON DIRECT INVESTMENT AND THEIR EFFECTS

Changing national policies toward international direct investment also affected and were affected by the volume and international dis-

[10] These factors are discussed at greater length in Christelow, "National Policies Toward Direct Investment" in Quarterly Review, Federal Reserve Bank of New York, Winter 1979–80.

[11] For a description of this important shift, see J. R. Donges, "A Comparative Survey of Industrialization Policies in Fifteen Semi-Industrialized Countries" Weltwirtschaftliches Archiv, Band 112, Heft 2, 1976; and

Anne O. Krueger, "Liberalization Attempts and Consequences," and Jagdish Bhagwati, "Anatomy and Consequences of Exchange Control Regime," vols. X and XI in Foreign Trade Regimes and Economic Development, National Bureau of Economic Research, 1978.

[12] "The Impact of Newly Industrializing Countries on Production and Trade in Manufactures," OECD, Paris, 1979 and World Development Report, IRBD, August 1980.

tribution of direct investment flows. During the decade, home country policies swung away from restriction toward neutrality, and even toward increased selective encouragement in the case of Japan. On the other hand, host country policies became increasingly interventionist, strongly encouraging some investments but reacting to other investment by new restrictive policies.

A. The Rationale Underlying Country Policies

The rationale for these diverse policies was partly economic, focussing on national or international welfare, and partly political and sociological. The neutralist view that gained some ground in host country policies is based on the economic proposition that permitting direct investment to respond to free market forces generally benefits both home and host country. An extension of free trade doctrine, the notion is that the absence of barriers to international flows of capital, technology, and managerial skills from areas where they are plentiful in relation to labor and raw materials to areas where they are less so, will maximize the total productivity of all factors of production for the world as a whole. However, there is no assurance that the results will be favorable at all times for every interest group in every country. Thus countries are most likely to support neutralist views when their competitive position appears to be strong. It is not surprising, therefore, to find that Germany's policy toward both inward and outward investment came closest to complete neutrality over the past two decades.

Among interventionists, some hold that appropriate government intervention in international direct investment helps along the world welfare maximization process usually attributed to free trade in goods and capital. One argument for host country intervention relates to "infant industry" trade protectionism that attracts direct investment as a substitute for exports to the protecting country. Such investment can increase world productivity if the economies of scale ultimately help new industry to operate competitively and without subsidies in world markets. It has been suggested that trade barriers may have induced some of this sort of investment in Canada.[13]

The case for home country intervention has been made by Kiyoshi Kojima, who has extolled the virtues of Japan's investment to develop foreign sources of raw materials and to assist the migration of labor-intensive industries to less developed countries. He noted that such investments (which were strongly supported by government) help LDC's to develop their potential, ease adjustment for labor-intensive industries in high wage countries by helping them migrate, and increase world trade.[14]

Other interventionists views are concerned with maximizing national gains in output and employment without much concern for world welfare. In such cases the assumption is sometimes made that direct investment entails a loss of output, employment, and income and negative balance of payment effects for the home country and corresponding gains for the host country. This line of thinking

[13] R. A. Mundell, "International Factor Mobility" American Economist Review, June 1957. Reprinted in Readings in International Economics (R. E. Caves and H. G. Johnson, eds.) 1968.

[14] "The Role of Foreign Direct Investment", Chapter 4 in Japan and the New World Economic Order," Westview Press, Boulder, Colo. 1977.

appears to underlie the recent efforts of many countries to attract foreign direct investment and the policies of some industrial countries to restrain outward investment, especially if domestically financed.

However, those assumptions have often been challenged. For example, tax concessions to induce investment may cost more than the additional income accruing to the host country from the investment. Protectionist trade measures designed to attract import substitution investment may reduce national productivity by encouraging investment in relatively low productivity sectors. Restraining outward direct investment by industries threatened by lower cost foreign competition may do little to stem declining exports challenged by lower-cost competition from other countries.

Turning to political and sociological considerations, most countries have shown great reluctance to allow foreign-owned companies to play dominant roles in domestic industries. There are three main objections. First, it is generally believed that foreign-owned firms are less responsive to national policies than domestic firms. This is partly because the international scope of their operations permit them to shift output and profits from one country to another, at least in the medium-term. But it is also because they are subject to conflicting regulatory actions taken by the numerous countries in which they operate. Some countries have also feared that powerful multinational firms possessing technological and managerial superiority and strong financial resources may stultify the development of domestic firms in the same industries. And finally, foreign-owned firms introduce alien cultural influences that may be unwelcome in the host country.[15]

The negative political and sociological aspects of international directs investment usually attract greater attention as the importance of foreign-owned firms in national economies increases. There has been some reaction in major European economies, where foreign ownership of domestic industry averages around 20 percent. In countries where the foreign control of domestic industry runs even higher—for example Canada, Australia, and the OPEC countries—negative sentiments have run still higher. Even in Japan, where the foreign influence is low on average, the dominant position of foreign-owned companies in its oil refinery and distribution industries since the early post World War II years may have stimulated that country's restrictions against foreign direct investment in the 1950's–1960's.

B. Policy Trends in the Late 1970's [16]

The direct investment policies of the 1970's reflect a pragmatic mix of neutralist and interventionist elements tailored to each country's strengths and weaknesses and to domestic and international political pressures.

[15] A clear exposition of these arguments as well as some of the economic arguments against encouraging inward investment may be found in "Foreign Direct Investment in Canada," report of a working group assisting the Honorable Herb Gray, D.C., M.P., Government of Canada, 1972.

[16] Useful tabular presentations of country policies may be found in: National Legislation and Regulations Relating to Transnational Corporations, United Nations Centre in Transnational Corporations, New York, 1978; Transnational Corporations in World Development, a Reexamination (Annex II) United Nations and Commission on Transnational Corporations, New York, 1978; and International Direct Investment, Policies, Procedures and Practices in OECD Member Countries OECD, Paris, 1979.

1. HOME COUNTRY POLICIES

As already noted, industrial countries are responsible for most outward investment. During the 1960's, all except Germany and Canada had imposed some restraints on outward flows, largely for balance-of-payments reasons. But they also gave at least limited encouragement to investment in developing countries, often as a supplement to development assistance.

In the 1970's, three major countries eliminated restrictions on outward direct investment. Japan took this step early in the 1970's as part of a broader effort to encourage capital outflows generally as a means of offsetting growing current account surpluses. That country subsequently experienced several years of current account deficits caused by the two oil price shocks of the 1970's, and the government's overall capital flow policy was adjusted on those occasions to offset the current account swings. But direct investment outflows remained relatively free.

The United States, which in the 1960's had limited domestic financing of outward investment, especially to Western Europe, phased out this and other capital controls beginning in 1974. That step followed the adoption of floating exchange rates between the major currencies, a move expected to eliminate the need for capital controls. The United Kingdom, which had generally prohibited domestic financing of direct investment outside preferred areas throughout the post-war period, abandoned that and all other exchange controls in October 1979. The move was part of the new Conservative government's drive to eliminate a wide variety of controls in virtually all areas of the economy.

For the remaining countries, the desire to maintain stable exchange rates with their trading partners and concern for the possible adverse payments consequences of outward direct investment led to continued restrictions on outward direct investment. They include: (1) preferences for investments that promote home-country exports and/or employment, (2) requirements that investment be wholly or partially financed by foreign currency borrowing, (3) limits placed on retained earnings in subsidiaries abroad, and (4) rules that all dividends be remitted to the home country.

Quite apart from their broad policies on direct investment outflows, most industrial countries have long provided at least limited support for investment in the developing countries. The main support measures have been: (1) insurance of selected investments against non-commercial risks—mainly war, expropriation and foreign exchange restrictions, (2) loans to help finance home country firms' investment in LDC's, (3) tax concessions on income from such investments (only in Japan). The U.S. program gives preference to investments in those countries having the lowest per capita income but there are no priority country groups in other national programs. A number of countries, including the United States but not Japan, limit insurance to the investments of small and medium-size firms. The scale of such programs has been extremely small except in the United States and Japan. Japan in fact stepped up assistance programs in the 1970's, when its loans to finance direct investment accounted for two-thirds of all industrial country loans of that kind.[17]

[17] The latest comprehensive data on country insurance and loan programs is that provided by OECD in Investing in Developing countries, Fourth revised edition, Paris, 1978.

Japan's encouragement of direct investment in the LDCs is explained by their importance for the country's overall industrial policies. Kojima's analysis of those policies as they relate to international direct investment has already been noted. Recent partly government-financed investments to ensure the availability of foreign raw materials have included a petrochemical plant in Iran, an aluminum smelting plant in Indonesia, and coal development in Australia.[18] Assistance given to the migration of labor-intensive Japanese industries to lower-wage less-developed countries has been especially helpful to larger textile and electronics firms. Investments abroad have bolstered their economic viability in the face of home competition for scarce labor from fast-growing high-productivity industries on the one hand and the threat of new production centers in developing countries on the other. Whereas the newly industrializing countries of Southeast Asia were the focus of this activity in the late 1970's attention has recently turned to direct investment in China.[19]

All in all, the most significant changes in home country policy were clearly those in Japan where liberalization plus encouragement of selected investments helped to quadruple Japan's contribution to international direct investment flows as shown in Table IV. That investment may also have increased productivity in Japan and in developing countries. The U.S. liberalization, which was confined to how direct investment was financed—with euro-currencies or domestic dollars—probably had little effect on investment levels or on the decline in the U.S. contribution to international investment. Removal of exchange controls in the United Kingdom has been too recent to allow any judgment of its long-term impact.

2. HOST COUNTRY POLICIES

During the 1970's host country policies turned more interventionists as both incentives and restrictions multiplied.

At present nearly all countries offer incentives to foreigners' investment in specified industries or areas. All industrial countries except Japan do so; most stepped up their efforts in the 1970's. In developing countries, a recent United Nations survey covering 31 countries indicated that half of them had enacted special legislation covering incentives during the 1970's while in the remaining countries such legislation was already on the books.[20]

Typically, incentives are offered to any investor, domestic or foreign, but special efforts are made to bring the offers to the attention of likely foreign investors. Investment promotion is mainly the concern of the central governments, but state, provincial and local governments also play a role in some developed countries. In the United States, efforts to attract foreign investors were entirely confined to the state and local level until 1980. Since then, the federal government has co-

[18] Export-Import Bank of Japan, Annual Report, Fiscal 1978.

[19] For example, investment plans of Canon, Inc. for assembly of low-price cameras in China was described in the Japan Economic Journal, International Weekly Edition, Oct. 14, 1980.

[20] United Nations Centre on Transnational Corporations, "National Legislation and Regulations Relating to Transnational Corporations," New York, 1978.

operated with the states and local authorities in this effort, emphasizing aid to investment in communities with high unemployment.[21]

Industrial countries have holidays from local taxes, accelerated depreciation for national income tax purposes, cash grants, training subsidies, low cost manufacturing plant, supportive infra-structure (e.g., roads) and subsidized loans. Inducements in developing countries are generally confined to tax holidays, waiver of import duties on equipment and materials and property tax exemptions.

One important and universal motive for subsidizing foreign investment has been to increase domestic employment. But in those countries where incentive programs are directed by the national government, there is also an interest in how subsidized foreign investment fits national objectives for development. Industrial and industrializing countries have favored high technology industries and those producing for export. A number of less developed African countries have subsidized investments in agriculture and agri-business and investment with special training programs for domestic workers and managers.

Many investment subsidies undoubtedly nurtured infant industries and ultimately increased world productivity. But subsidies have become so large and competitive in recent years that they have attracted considerable criticism. Some observers have likened them to competitive tariffs and other protective trade measures and have recommended international negotiations to reduce them—a kind of GATT for international direct investment.[22]

Notwithstanding major competitive efforts to induce inward investment, all countries also exercise some discrimination against foreign investors for the political and sociological reasons already mentioned. In a number of countries where the foreign presence had acquired major importance by the end of the 1960's, the disadvantages of foreign investment became more compelling and negative discrimination intensified during the 1970's. The main forms of discrimination currently being practiced are: barring or limiting foreign entry into strategic industries; screening proposed investments by foreigners; informal monitoring procedures; subsidizing domestically owned companies to discourage entry by foreign-owned companies; use of national regulatory procedures to limit foreign investment; government purchacse of foreigners' equity in existing enterprises; "unbundling" direct investment.

Reserving strategic industries for domestic ownership and control or severely limiting foreign entry into those fields is probably close to universal. Those industries most commonly treated in this way are public utilities, communications, and transportation. But foreign investment in resource industries and banking is also fairly frequently restricted in both industrial and developing countries.

Formal screening procedures exist for all industrial countries except the United States, Germany, Switzerland and (since late 1979)

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[21] See U.S. Department of Commerce, Business America, Aug. 25, 1980. The Economic Development Administration of the Department of Commerce has financed access roads and industrial park site improvements and provided loan guarantees, while the Housing and Urban Development Department (HUD) has financed the construction of industrial plant for foreign investors. Further, various government departments plan to prepare information on investment opportunities that may be used by state and local governments and by U.S. embassies and consulates abroad in bringing investment opportunities to the attention of foreigners.

[22] See for example, the "Need for International Cooperation in the International Investment Area," remarks by Honorable C. Fred Bergsten, Assistant Secretary of Treasury for International Affairs before the Second Annual Conference on International Tradie and Investment Policy of the National Journal, May 11, 1979.

the United Kingdom. In Canada, screening criteria are carefully spelled out by the Foreign Investment Review Act of 1979. They include the effect of investment on output, employment, the balance of payments and domestic competition, as well as its contribution to national objectives. In Italy those investors wishing to be assured of unlimited repatriation privileges are required to demonstrate that their investments will increase Italian output.

In other countries, specific criteria are not spelled out in legislation and are, therefore, quite fluid. One of the main concerns appears to be how inward investment is financed. For example, France requires that much of it be financed externally while Denmark and Finland limit external borrowing by foreign-controlled firms. Another concern relates to foreign take-overs of domestic companies. For example Japanese authorities will not authorize a takeover which has not been agreed to by the target company, and France sometimes prohibits even friendly take-overs judged not to be in the public interest.

Two countries have enacted special legislation on foreign takeovers. Australia's Foreign Take-Over Act of 1972 gives the government the right to review and, if in the national interest, to prohibit foreign takeovers. And in the United Kingdom, where routine screening in connection with foreign exchange controls has been abandoned, the Industry Act of 1975 still gives the government power to prohibit foreign take-overs of important manufacturing firms and to acquire take-over targets to protect the national interest.

In developing countries, screening for establishment of foreign investment is widely practiced in Asia, the Middle East, North Africa and Latin America, but is not common in Africa. Where such screening does exist, it is closely integrated with screening for investment incentives and follows the lines already mentioned in that connection. Blanket regulations setting a minimum percentage for local equity participation (usually 51 percent) and requiring local participation in management are also quite common.

The use of general regulatory powers or subsidies to domestic firms to limit or reduce the influence of foreign firms are devices used chiefly in industrial countries. For example, in Germany a recent decision of the Federal Cartel Office permitted a merger between German tire firms in order to improve their ability to compete with foreign tire firms within Germany and throughout Europe. And in Canada, the government is currently offering subsidies for oil exploration scaled to the degree of domestic ownership of the exploring corporation.

Government takeovers of foreign-owned firms accelerated during the 1970's. According to a United Nations count,[23] there were 455 takeovers in the 1960's and double that number between 1970 and 1976. In the latter period, petroleum and mining, taken together, headed the list with 228, followed closely by banking and insurance at 216. There were 174 takeovers in agriculture and only 145 in manufacturing. In value terms, the OPEC countries probably led the list. However, there were other significant takeovers in numerous countries in Asia, Africa and Latin America. In addition, in Canada, the federal and provincial governments acquired full or part ownership in a number of resource firms from foreign owners. Takeovers and purchases reduced net in-

[23] United Nations Commission in Transnational Corporations, Transnational Corporations in World Developments, May 1979.

vestment in those countries to minimal or negative amounts in the years that they occurred, greatly slowing the overall rate of international direct investment.

In the developing countries, purchases of foreign-owned equity was often part of a process that has come to be known as "unbundling". That is, after acquiring ownership of the facility in question, the host country purchases management services and technology either from the firm it has bought out or from other foreign firms. This process is designed to retain the advantages and reduce the disadvantages of foreign direct investment for the host country. It has been largely confined to the resource industries where locational factors make the bargaining position of the host country exceptionally strong.

The net effect of host countries' positive and negative interventionist policies was to increase direct investment in manufacturing while reducing it in resource industries. The extent to which these investments increased or reduced world productivity and thus real growth is not easy to judge.

IV. Current Policy Problems for the United States

International direct investment policy is an important element in U.S. foreign policy as a whole because U.S.-based multi-nationals continue to play a major role in global direct investment flows. It is also an important element of domestic policy in view of its impact on employment, the competitive position of domestic industries, and national strategic concerns.

From 1974, when exchange controls on the financing of outward direct investment were lifted, until 1980, the policy of the federal government was close to neutral on both outward and inward investment. This position parallels its advocacy of free trade principles. The government has also favored neutral policies in international negotiations to establish direct investment codes at the Organization for Economic Cooperation and Development (for industrial countries) and at the United Nations (for both industrial and developing countries). In both cases, U.S. officials have favored reducing competitive subsidies to inward investment and eliminating discriminatory treatment of foreign-owned companies.

While the United States' direct investment policies have been closer to neutral than those of most other industrial countries, its policies on inward direct investment seem to be moving toward intervention. This is probably partly a response to the rising importance of those flows relative to outward investment. In 1979 and 1980, foreign investment in the U.S. averaged $11.4 billion a year, more than half the size of outward investment and sharply higher than the 20 percent ratio prevailing a decade earlier. More strikingly, new foreign investment in this country (excluding reinvested earning) averaged $6.3 billion in 1979–80, more than twice the size of new U.S. investment abroad.

The United States policy shift is also in part a response to increasingly discriminatory policy in Canada. That country is currently seeking to reinforce an already evident trend away from foreign ownership and control of the Canadian petroleum industry. To this end the Canadian government has introduced new subsidies for

oil exploration on public lands, keying the subsidy to the degree of Canadian ownership, and the Canada Development Corporation has recently purchased Elf Aquitaine Canada from its French owners.

The only interventionist policy which the United States has implemented thus far is in the area of subsidies. As noted earlier, the federal government has recently supplemented state and local efforts to attract employment-boosting investment in manufactures. But a number of restrictive measures have been proposed. In 1980 a congressional committee recommended that all incoming foreign direct investment be subject to official review.[21] One purpose was to improve our statistical information on direct investment. But the report also seems to suggest that criteria be established for distinguishing desirable from undesirable investments and for curbing the latter.

In 1981, in a reaction to Canada's efforts to reduce foreign investment in its energy resources at a time when Canadians have been investing heavily in this country, legislation was introduced in the U.S. Congress to limit foreign exploitation of energy resources on U.S. public lands. Similarly, since Canadian investors have access to credit to finance takeovers under less restrictive Canadian banking regulations, legislation has been introduced to subject foreign investors to U.S. restrictions. These and other proposals are motivated by a growing sentiment that the "rules of the game" are not fair to the United States and are becoming more unfair at least in relation with Canada.

Canada, for its part, has defended its recent policies on foreign investment in Canadian resource industries as no more restrictive than in many other resource-rich countries. But it has shown understanding for U.S. complaints regarding Canadian investment in the United States, requesting its chartered banks to reduce their financing of Canadian takeovers of U.S. firms.

Recent United States experience with rising inward foreign direct investment, though worrisome at times, could benefit international investment relationships in the longer run. This country is undoubtedly gaining a deeper understanding of the concern which its own investment has created in other countries. Further, its own attractiveness as an area for profitable foreign direct investment gives the United States a new bargaining chip in its negotiations with other industrial countries. The United States will do well to use its considerable bargaining power to work for reduced subsidy competition among nations for multinational's investment and for a reasoned compromise between domestic and foreign investment in the development of resource-rich countries.

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[21] "The Adequacy of the Federal Response to Foreign Investment in the United States," Twentieth Report of the Committee on Government Operations, U.S. House of Representatives, Aug. 1, 1980.

FINANCE

THE EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM

By Henry C. Wallich*

The international monetary system is in a state of rapid evolution. The existing system, with its heavy dependence upon the dollar seems destined to change in one way or another because of waning world satisfaction with the manner in which the dollar has been performing its role as almost the sole key currency. A natural successor to the dollar would be the special drawing right (SDR) of the International Monetary Fund (IMF). As a composite of five currencies, it possesses greater stability than any one of them. An attempt to move the SDR closer to the center of the international scene, through the creation of a substitution account that would absorb dollars and issue SDR claims, has had to be put on ice. Meanwhile, the European Monetary System, focusing upon the ECU, is making unspectacular progress.

In the absence of wider use of the SDR, national currencies, such as the D-mark, the yen, and the Swiss franc, are likely increasingly to share the role of the dollar. The world is moving toward a multicurrency reserve system. This is not a happy prospect, because such a system contains a built-in tendency toward instability. As one currency comes to appear more attractive than another, holders are likely to shift into it, causing exchange rate fluctuations to widen.

Nevertheless, the world could probably live with such a system. Its stability can be enhanced by domestic monetary and fiscal policies conducive to greater price stability in the major countries. Efforts to achieve currency stability by abandoning the floating system in favor of fixed rates are likely to be unavailing and might lead to trade restrictions. Nor would attempts to retrieve international monetary stability by moving gold back into the picture be at all promising. Strengthening the role of the IMF will help and will give us a chance to avoid a worldwide deterioration of the payments system, such as caused the financial ice age of the 1930's. Continuous international cooperation, however, and domestic policies shaped to support the international monetary system will be essential to the survival of the system.

Introduction

One piece of wisdom was left to posterity when the attempt to redesign a blueprint for the international monetary system was given up in 1974. The International Monetary Fund's Committee of 20, that had labored for two years on the project, concluded that the interna-

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tional monetary system would continue to evolve. No truer word has been spoken on this seemingly immortal topic. The system certainly has been and is in continuing evolution. Some of its evolution has been along structural lines, changing the nature of its organization. Among present departures in this area are the work on a substitution account, the European Monetary System and the effort to strengthen IMF surveillance. Drift toward a multicurrency reserve system could bring a further structural change. Reviving interest in gold has revived also suggestions, impractical in my view, for a new fixed price of that commodity.

Policies carried on within the international monetary systems as it currently exists have also been evolving. There have been movements along various spectra of options. One such spectrum runs from fixed to freely floating rates. Here, the initial move toward free floating has been in some degree reversed in the direction of more management. Within a second spectrum, running from preference for appreciation to preference for depreciation, a shift of preferences toward strength rather than weakness of national currencies has been observable. Finally, in the spectrum of options for dealing with payments deficits by adjustment or by financing, a move toward greater emphasis on adjustment may be ahead for many countries in this second round of OPEC-induced payments deficits. I would like to deal briefly with all of these elements of monetary evolution.

The SDR

The Articles of Agreement of the International Monetary Fund call for the SDR (Special Drawing Right) to become the world's principal reserve asset. In concept, this is to be achieved by gradual allocation of SDRs to IMF member countries; in the course of time these SDR will take the place of gold and of national currencies in countries' reserves.

This conception reflects the situation prevailing during the middle 1960's, which reflected concern over an impending liquidity shortage. It was believed that the supply of gold available for use in national reserves would be insufficient to meet reserve needs while the progressive expansion of the use of the dollar as a reserve medium would eventually undermine the dollar's convertibility into gold. To meet the supposedly oncoming shortage of liquidity, the SDR was established as an extension of gold, sometimes referred to as "paper gold," making its issuer, the International Monetary Fund, an embryonic world central bank.

Events have not borne out the expectations of that earlier period. The supply of world liquidity did not dry up. By most standards, it became excessive, partly as a result of large payments deficits on the part of the United States which caused other countries to acquire dollars, but more fundamentally through the experience that reserves could easily be replenished and indeed replaced by the credit facilities offered by private financial markets. As it became increasingly realized that excess liquidity rather than liquidity shortage was becoming the problem, the principal motive for SDR creation and allocation disappeared. There remained the desire of a number of countries, mostly developing countries, for a costless increase in reserves and relatively cheap credit, which could be met by the holding and use, respectively,

of SDR. (Countries pay interest to the IMF for SDR they use, but not for those they hold as part of their original allocation.) Under these circumstances, the allocation of SDRs was suspended in 1972 but resumed in 1979. Some of the industrial countries expressed a concern that continued allocation of SDR in the absence of a liquidity need would convert the instrument into an aid device, weaken the IMF, and undermine the prospects of the SDR as a reserve asset.

Meanwhile, however, important changes were being made in the terms and conditions governing the SDR. They were designed, or at least had the effect, of making it more attractive principally to countries receiving SDR's through international payments but also to some extent to countries using them for that purpose. Several features of the SDR had made it cumbersome and unattractive. One was the reconstitution obligation, requiring users to maintain over a five-year period an average balance in SDR's of 30 and later of 15 percent of their average allocations. Another was the low interest rate paid to recipients of SDR in international payments (60 and later 80 percent of the average Treasury bill rate in five currencies). Still another was the difficulty of computing the value and interest rate of an instrument constituting an average of 16 currencies and five interest rates. To make the SDR more attractive, the reconstitution requirement was eliminated, the interest rate raised to the market level, and the number of currencies in the basket reduced from 16 to 5. The acceptance limitation, i.e., the maximum of SDR's that a country as a member of the IMF was committed to accept if offered in payment, remained at three times the original allocation, reflecting the basically skeptical attitude of creditor countries toward the SDR.

A major opportunity to broaden the use of the SDR was put aside when the plan for a substitution account in the IMF failed of acceptance at the meeting of the IMF Interim Committee in Hamburg on April 25, 1980. The substitution account was to absorb supposedly unwanted dollars from major official holders and to replace them with SDR. This would have reduced the role of the dollar in official reserves and increased the role of the SDR. The dollars received by the account were to have been invested in U.S. Government securities. The interest on these securities would have financed the interest payment on the SDR. The account would have been an independent entity within the IMF. The IMF would have had no responsibility for the SDR issued by the account or the interest due on them. The obligations of the account would have been backed exclusively by its dollar assets.

The difficulty to be overcome was to maintain adequate coverage for the liabilities of the account and the interest thereon, by means of the dollar assets and dollar interest earnings of the account. A decline of the dollar against the SDR would have put the account into deficit, and a decline of dollar interest rates below the amounts needed to service the SDR interest would have put the account into income deficiency.

The United States, as the debtor in the scheme, and the potential creditors of the substitution account, were unable to agree on a method to guarantee the equivalence of these balances and interest flows or on a sharing of the risks in case they should diverge. The United States viewed the scheme as a long-run restructuring of the world monetary system to the benefit of all, which implied an equal sharing

of risks and costs. The potential creditors seemed to regard the scheme as a bail-out for the dollar in which case costs and risks should fall principally on the United States. The implication of the deadlock was that the dollar-holding countries were not sufficiently eager to replace their dollars with SDR, and the United States was not sufficiently eager to consolidate its liquid dollar liabilities into long-term dollar obligations. Both sides preferred the risks and opportunities of the existing situation. It was a kind of backhanded compliment to the dollar that, from the point of view of the Europeans, of course, proved justified when the dollar subsequently appreciated far above the exchange-rate level at which SDR's would have been substituted for dollars if that substitution had taken place soon after the abortive Hamburg Interim Committee meeting.

But while the SDR suffered a setback at the official level, new opportunities seemed to open up in the private sector. Under conditions of floating exchange rates, a feature became apparent which had not been considered during the fixed-exchange-rate period in which it was first developed. This feature was its capability as an exchange risk diversifier. So long as exchange rates were expected to remain stable, this feature did not attract much attention. When floating rates began to induce some official and private holders of foreign currency balances to diversify, the SDR was seen to offer ready-made diversification in major currencies. Wide swings in exchange rates, including strength of the dollar and weakness of some of the currencies that had attracted diversification, may have reduced the confidence of market participants that they could anticipate rate movements and do better by mixing their own portfolio than by accepting the fixed SDR mix. Aided by this developing attitude, private obligors, banks and nonbanks, have begun to issue their own SDR liabilities on a modest scale. These "SDR claims" are not to be confused, of course, with the SDR proper issued by the IMF or the SDR claims that would have been issued by the substitution account. They are simply the obligations of the issuer denominated in a new synthetic currency, the SDR. As such, their appeal rests on the credit standing of the issuer and the degree to which the interest rate paid matches market rates on assets denominated in the component currencies.

While this new function of the privately issued SDR is still in its infancy, it does seem to offer at least conceptually the possibility of greatly broadening the role of the SDR as a unit of account, even though not as an increase in the world's supply of paper-gold. Moreover, since many central banks hold Euromarket CDs and similar paper in their reserves, it is not unlikely that in the course of time they may come to own CDs denominated in SDR, issued by the same prime banks. The possibility thus exists that privately issued SDR claims may become an important reserve asset, making it unnecessary for the IMF-issued variety to expand greatly in volume in order to assume that role.

The European Monetary System (EMS)

The European Monetary System constitutes another direction of structural evolution, toward creating a zone of exchange-rate stability and incidentally limiting the role of the dollar in intervention by the participating countries. The system now has been in operation for

about two years. Neither the hopes nor the fears associated with its creation seem to have been more than very partially validated so far. The system per se does not seem to have produced the greater discipline on its members that would have helped to bring down national rates of inflation. But neither has it led to exaggerated exchange-rate rigidity or payments controls. In some measure it can be held responsible for the higher inflation now prevailing in countries where inflation was low, before the recent oil price increases, because it has kept some of the high-inflation members of the EMS from depreciating and has thus compelled the low-inflation members to import more inflation. By the same token, it has held down inflation in the high-inflation group.

Some of the smaller members may have felt that their currencies were pulled along excessively by the D-mark. Some also may have felt under a constraint to match German interest rates more than they would have wanted to for domestic purposes. That, of course, is what discipline means.

For the United States, the EMS has not had the result that some may have feared—a coordinated European dollar policy aiming at control over the value of the dollar. At times it has had the anomalous effect of pulling up, relative to the dollar, the currencies of some countries whose rates of inflation were no less than those of the United States, in circumstances when the U.S. current account was improving. Since the EMS, under the terms of its charter, is to evolve in the direction of tighter cohesion, its effects may change over time.

Suggestions have been made that arrangements similar to the EMS could be devised for the dollar area or for the Pacific Basin. The benefits derived so far by the European system do not suggest that there is something here that urgently requires application elsewhere. But in any event, the problems encountered in the European system, less difficult there, would almost certainly become much more visible in a Western Hemisphere or Pacific Basin context, such as widely differing rates of inflation—the United States and Canada on one side, Latin American countries on the other—and a history of wide exchange rate fluctuations that would be difficult to confine—United States and Japan, Japan and other Pacific Basin countries.

International Liquidity

Creation and control of international liquidity has always been regarded as an important feature of the international monetary system. During the 1960's, there was concern about inadequate liquidity under a system that seemed to be throwing increasing burdens on the U.S. dollar. The creation of the SDR was the response which eventually turned out to be at least premature. During the 1970's, concern was primarily with excessive liquidity. International reserves could readily be obtained by borrowing from the private market. Reserve requirements, on the part of OPEC and of countries that sought to keep their currencies from appreciating under the floating system by buying dollars, became very large.

Traditional analysis would imply that high liquidity is an inflationary threat. Inflation has indeed been rampant, but it is not easy to trace it back to excessive international liquidity. One reason is that much of the additional liquidity has accumulated in the hands of coun-

tries that normally pursue strong anti-inflationary policies and thus are unlikely to take advantage of their high liquidity. Countries likely to overspend internationally do not have excessive reserves, perhaps precisely because they have not followed strongly anti-inflationary policies.

Recently, high liquidity has been "absorbed" in a sense, by the rising volume of international trade and mounting payments imbalances. Liquidity, in other words, is not as excessive as it might appear. This reduces the need to be immediately concerned about how to curb excessive liquidity creation. Nevertheless, for the long run the danger exists and policies bearing on international liquidity such as the creation of SDRs by the IMF, the possible treatment of gold reserves of the Fund and of national authorities, as well as possible control of the Euromarkets, will have to take account of it.

IMF Surveillance

The IMF has the power, and indeed the obligation, to exercise surveillance over the exchange rate policies of its members. The Fund has been given the power also to monitor the monetary and fiscal policies of its members, since these are important determinants of exchange rates. Finally, as a third perimeter of surveillance, the Fund can examine members' policies with respect to the financing of their payments deficits. The surveillance process covers countries in surplus, influence over whose policies has always been a weak part of the adjustment mechanism. To implement the surveillance process, the United States has proposed that countries with large imbalances submit to the IMF proposals for dealing with them, that the Fund assess the performance of individual countries in a global context, that the Managing Director more often take the initiative in arranging consultations with members, and that the IMF examine how payments imbalances have been financed.

The Fund has approached its task of surveillance with a great deal of caution. It is significant, however, that the United States has declared itself willing to accept this degree of IMF influence. Historically, the United States has been resistant to any thought of IMF influence over our freedom of domestic decision-making. One may view this evolution of U.S. thinking as evidence that the United States increasingly realizes that its domestic policies may benefit from balance-of-payment discipline, as well as finding greater activity of the IMF in this area in the U.S. interest generally.

A Multicurrency Reserve System

The drift toward a multicurrency reserve system is not an organized process. It seems to be happening, in some degree, as a result of diversification efforts on the part both of some central banks outside the G–10 group of countries and of some private sector participants. Such a move is not surprising under a system of floating rates. A diversified portfolio, whether of common stocks or of currencies, has less risk for a given rate of return than investment only in a single company or a single currency. In choosing the desired composition of their currency portfolio, holders presumably will give weight to the distribution of currencies in which they conduct their imports and in which their

debts are denominated. That would still leave a very sizable demand for dollar assets. Indeed, the share of the dollar in monetary authorities' portfolios of foreign exchange holdings since 1973 has been fairly constant at about 80–85 percent.

The world has had experience with multicurrency reserve systems before. Gold and silver, sterling and dollar, gold and dollar, with an admixture of French francs, have all been tried by force of circumstances and have been found to be unstable as holders switched from one asset to the other. A new edition of the old text probably would not turn out very differently. It might be noted additionally that the countries whose currencies are candidates for reserve-currency status at first were far from enthusiastic about the prospect. More recently they have been pushed to a more positive stance mainly by the desire to obtain financing for the payments deficits resulting from higher oil imports. This motivation is not necessarily a commendation of a multicurrency reserve system.

An alternative to a multicurrency reserve system would be an SDR-based system. An SDR-based system, employing the newly established five-currency basket, seems far preferable. To be sure, the lack of progress made by that instrument since its creation in 1969 might give one pause. One should think that, if the SDR were a promising financial instrument, the private market would have created and popularized its counterpart, the SDR claim. So far, very few borrowers outside those from the IMF have wanted to borrow in SDR, and few depositors have sought SDR deposits. A demand for such instruments, if it were manifested, could, of course, be accommodated by the private banking system as well as by other financial institutions.

The fact that the interest rate on the SDR has been kept artificially low is not a complete answer. It applies only to the SDR that is issued as a liability of the IMF. The potential role of SDR-denominated claims and liabilities is much wider. Borrowers and lenders could put on such instruments any interest rate commensurate with interest rates in the underlying basket or part thereof, or even an independent interest rate.

Nor is it a valid explanation of the failure of the SDR claim to find customers so far that its rate of return, taking 100 percent of the computed interest and the appreciation or depreciation against particular currencies into account, has been less than the total return on the strongest currencies. Ex post, the same can be said about any successful asset—it tends to outperform the total return on an average portfolio. But that does not prevent most investors from preferring diversified to highly concentrated portfolios. In the exchange market, any currency may be expected so to position itself that its total return, interest plus expected appreciation, is equal to that of other currencies allowing for factors of convenience and political risk. Ex post it will undoubtedly turn out that some currencies appreciated or depreciated in ways not expected, making total returns unequal. An investor gifted with superior foresight could take advantage of this. But the average investor or monetary authority will be better off with the lower risk of a diversified portfolio, of which the SDR claim, and to a lesser extent the ECU, are prime instances.

A means of easing the transition to a multicurrency reserve system and of avoiding the market effects of sales of dollars for other curren-

cies is sometimes suggested. It consists in an arrangement whereby the monetary authorities of potential reserve-currency countries would make available their currencies to foreign monetary authorities against payment in dollars outside the exchange market. The same avoidance of market disturbance, but with less risk for the buyer and less exposure to reserve-currency status for the seller, could be achieved if a central bank in that situation were to issue SDR liabilities. So long as SDR claims are not widely acceptable among central banks, a central bank issuing such liabilities would probably have to stand ready to convert them back into dollars or into its own currency at the prevailing exchange rate. Eventually, SDR claims might move in official or private market channels much as bank liabilities denominated in national currencies do today. The risk for the issuing bank, which acquires dollars, would in any event be less if it issues SDR liabilities against these dollars than if it issues its own currency.

No Return to the Gold Standard

The rise in the price of gold has encouraged suggestions that the monetary problems of the world could be solved by putting gold back in the center of the picture, fixing its price (by committing to buy and sell at this price), and starting a new ballgame. The implausibility of these proposals is easily seen if one notes their consequences. Suppose a single country were to fix a price for gold. It is most unlikely that that price would be one at which the market neither wants to sell nor buy gold on balance. If the price is too low, the country will find itself selling out its gold reserves to the market. If the price is too high, the country will find itself acquiring large amounts of gold and pouring out liquidity. The experience of the gold pool of the 1960's, which after all operated in a world still accustomed to stability, is a faint foretaste of that situation. The experience of the United States during the 1930's is also indicative. Following the rise in the price of gold from $20.67 to $35.00 per ounce, U.S. gold holdings rose from 195 million ounces in January 1934 to 419 million ounces in January 1939, although some of the movement probably reflected war fears.

If several countries were to fix the price of gold, they would then effectively have fixed their exchange rates against each other. We would be back in the Bretton Woods system, but with much higher rates of inflation, and greater variation of inflation rates. Exchange rates would quickly get out of line, and the gold pegs would be broken.

Such a result could be avoided only if countries were to subject their domestic policies to a severe discipline designed to keep their domestic price levels and their balances of payments in line with arbitrarily fixed exchange rates. That would mean the full discipline of the gold standard. Some of the proponents of a return to gold seem to desire the imposition of such discipline. Whether that kind of harsh discipline is desirable, or whether it would just make us repeat the experience of 1931–33, its achievement today seems altogether out of reach. For some countries, moreover, the discipline might work in reverse—forcing them to inflate when they do not want to inflate.

The more likely consequence of the rise in the price of gold to date is a reduction in discipline, if gold-holding countries were to take advantage of their new-found wealth. Looser fiscal policies and monetary

policies, and looser balance-of-payments behavior, could all be financed if present gold profits were mobilized by a write-up of gold assets. It will take some effort to prevent this from happening in particular circumstances.

Between Fixed and Freely Floating Rates

Since generalized floating began in March 1973, the degree of acceptance of free floating has varied from country to country and from time to time. To the extent that there ever was acceptance of perfectly clean floating, there clearly has been a movement away from that position. At the same time, however, there seems to have been some convergence of views internationally that exchange rates cannot be determined by fiat or market intervention, but must be left to the determination of fundamental factors such as the rate of inflation, the current account, capital movements, and the rate of interest. It is recognized, of course, that these fundamentals are in good part themselves determined by national policy actions.

The difficulty of controlling exchange-rate movements by intervention was demonstrated, for instance, in 1977, when foreign central banks bought approximately $35 billion without being able to prevent the decline of the dollar. Japan, over the period January 1979–January 1980, reduced its reserves by about $12 billion without preventing a substantial depreciation of the yen.

Nevertheless, in a minor key, market intervention has come to be recognized as a means of countering not only day-to-day disorder, but disorder also in a broader sense. The history of exchange-rate movements during the period of floating suggests that exchange rates often overshoot on the upside as well as on the downside. Whether this reflects simply speculative bubbles and bandwagon effects, or differences in the speed with which asset markets and goods markets clear, a case has been seen to exist for countering excessive market movements. The United States today stands alone in limiting intervention to instances of high disorder.

Appreciation Versus Depreciation

Much of the Bretton Woods thinking about exchange rate policy derived from a fear of competitive depreciation. If this fear ever prevailed during the period of generalized floating since 1973, it has proved to be superfluous. The much more general tendency among countries has been to aim at a strong currency.

Many factors have contributed to this. Nowadays, a country suffering from unemployment can deal with it by domestic expansion. It needs no recourse to exchange depreciation to promote employment by stimulating exports. A declining exchange rate, on the other hand, has been observed to contribute to inflation and also to reduce the scope for domestic expansionary measures that would create adverse exchange rate expectations. Vicious circles of inflation and depreciation have acquired an ominous reputation, while virtuous circles of appreciation and lower inflation have seemed worthy of emulation.

As regards the dollar, the case for strength has gained from its reserve-currency role. Weakness of the currency in which the world carries its reserves, in which it trades and invests, is bound to create

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uncertainty, instability, and a propensity to systemic changes. Not all currencies can rise at the same time, but during a period of worldwide inflation, all countries can pursue domestic policies designed to strengthen their currency to their own and the common good.

Financing Versus Adjustment

When the first OPEC price increase hit the world and created the prospect of a period of enormous deficits, it was widely recognized that a universal effort to eliminate these deficits by internal contraction or depreciation would be futile and possibly disastrous. Now that OPEC-induced deficits have mounted again, the same issue reappears, but with different accents. Countries that relied heavily on financing their deficits instead of adjusting them away during the earlier round will find it preferable, and perhaps necessary, to lean the other way this time. Their debt burdens, and the limited capacity of banks to accumulate obligations of particular countries, makes this advisable. Thus, within the spectrum that runs from adjustment to financing of deficits for countries already heavily in debt, the accent should shift in the direction of earlier adjustment and less financing. Given that the OPEC-imposed deficits in the aggregate cannot be reduced quickly, this would mean that countries that are able to finance their deficit would have to accept larger deficits.

The International Monetary Fund

The continued effective functioning of the International Monetary Fund is an important condition for weathering the difficult period that is likely to be ahead in international markets. The IMF has been involved in almost all the dimensions of the international scene examined in this paper. There is no need, therefore, for a special discussion of its role. In terms of international discipline, the IMF probably is the most influential international institution in existence. Whatever there is of an "international monetary system" is rooted in one way or another in the IMF. That the system has not been weakened more than it has is in good part attributable to the IMF. The IMF is still far removed from a world central bank role. But, unless the European monetary fund should in time accede to that role, the IMF is the most likely candidate.

Conclusion

As we view the evolution of the international monetary system, we have reason to reject the allegation that the system is in the process of disintegration. It is true that fixed rates have come to an end, that we may be moving to a multiple currency system and that the appearance of shifting trends, such as sketched in this paper, in lieu of stable rules of international financial behavior, may convey the impression of disintegration. But the system has produced on the whole good results. The first oil crisis has been weathered, trade has expanded, international capital flows have been enormous. The ultimate calamity—worldwide trade restrictions and a freezing over of international payments as happened during the 1930's—has been conspicuously avoided.

RECYCLING AND THE DEBT PROBLEM OF DEVELOPING COUNTRIES

By William R. Cline*

The external debt of developing countries warrants close attention in a review of the international economic agenda. That debt has grown rapidly in the past decade. For many developing countries there is a risk that limitations in the international system of financial recycling will pose an obstacle to economic growth in the coming years. And there is an outside chance that breakdowns in the orderly servicing of LDC (less developed country) debt could jeopardize the entire international financial system.

Viability of the Financing System

The most sensational question about LDC debt is whether some day a wave of defaults might bring down foreign banks and trigger a world-wide financial crisis. Most analysts consider such a scenario to be remote, although there is a historical precedent from the 1930's.

It is true that U.S. and other foreign banks have become heavily dependent on loans to LDC's. In 1979, loan exposure in non-oil developing countries amounted to 112 percent of bank capital for all U.S. banks, and 161 percent for the nine largest banks.[1] A general default on LDC debt would wipe out private bank capital, necessitating huge rescue measures by the Federal Reserve.

It is also true that LDC debt has grown rapidly. From 1973 to 1980, it multiplied 3.7 times, reaching about $300 billion in 1980. The largest cause of this rapid run-up in debt was the oil price shocks of 1973–74 and 1979–80. On the other hand, the increase in total external debt was largely in nominal terms; in real terms, the expansion was only 37 percent. Moreover, the export base for servicing debt almost kept pace with the rapid rise of debt. Table 1, for example, shows external debt rising substantially but not alarmingly, from about two-thirds of the annual level of exports of goods and services in 1973, to four-fifths of these exports in the late 1970s. Similarly, in 1979 and 1980, the current account deficit as a percentage of exports of goods and services of the non-oil developing countries at 18 percent was not dangerously high (and actually lower than in 1974–75).

At the aggregate level, then, the non-oil developing countries appear to have high, rapidly growing debt, but so far it remains at manageable levels. Nevertheless, a financial crisis might conceivably be precipitated if a number of large individual borrowing countries all interrupted their debt servicing. In most cases, debt difficulties lead to orderly rescheduling of debt with no serious strain on the balance sheets of lenders.

More importantly, a listing of the major borrowers suggests that very few are prime candidates for debt rescheduling, let alone default.

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[1] Paul L. Volcker, "The Recycling Problem Revisited," Challenge, July–August 1980, p. 6.

Table 2 shows the debt of the 20 largest borrowers among the LDC's. These countries represent 77 percent of all LDC debt. Among these large borrowers, several are creditworthy because of oil exports: Mexico, Algeria, Indonesia, Venezuela, and Nigeria. Several others are relatively self sufficient in oil: Egypt, Argentina, Peru. Among the others, only a few show sharp increases in the ratio of debt service to export earnings (an indicator of debt servicing burden) from 1973 to 1979: Brazil, the Philippines, Morocco, and Chile. In addition, Turkey and Zaire have experienced debt servicing difficulties. Excluding Brazil, these five countries account for only $34 billion in debt, slightly over one-tenth of the total. Thus, if Brazil is excluded, it is difficult to see what debtor countries might be capable of precipitating a system-wide crisis.

Brazil is a special case. The largest debtor, with more than $50 billion in external debt, it is probably the only country whose actions could have system-wide consequences. Brazil raised its exports sharply in 1980, and its debt indicators are now more favorable than in 1978–79. Nevertheless, it warrants surveillance, in part because its inflation, at over 100 percent annually, has foreign banks worried, jeopardizing the ongoing flow of new credits that is necessary to avoid a liquidity crisis.

The other special case worth mentioning is Poland, not a developing country. At over $25 billion, Poland's debt is sufficient to raise the possibility of at least localized crises in the financial system in the event of a default. Already private banks have had to reschedule payments due in 1981, and public rescheduling is in progress. Political events in Poland do not provide reassurance that all will be resolved by antiseptic reschedulings. Nevertheless, the financial system could probably weather a default of this magnitude without severe repercussions. In sum, the aggregate figures suggest that the LDC debt problem is manageable from the standpoint of avoiding a system-wide financial crisis. The same conclusion emerges from the detailed figures for the major borrowing countries, although Brazil and Poland warrant special attention.

Two recent reports came to broadly the same conclusion as suggested here: LDC debt is unlikely to cause a collapse of the financial system, but nevertheless it warrants careful attention because of risk to the system. A study by the International Monetary Fund [2] emphasizes that the LDC debt has not grown excessively relative to exports, GDP, and foreign exchange reserves, but the study acknowledges that the burden of debt service has grown larger; the ratio of debt service to exports has risen from 16 percent in 1970–72 to 19 percent in 1979. The other report, by the Rockefeller Foundation-sponsored group of experts known as the Group of Thirty, is more concerned about "default risks in international lending." These experts conclude:

> . . . if a large number of large or medium-sized debtors were to request restructuring within a short period, and interest payments on outstanding debt were to fall below the cost of carrying these loans to the banks, the possibility of a break in confidence would clearly be increased.
>
> . . . In short, there are default risks in international lending; in our view, these risks are increasing." [3]

[2] Bahram Nowzad and Richard C. Williams, "External Indebtedness of Developing Countries" (IMF, Washington, D.C., 1981).

[3] Jacques. J. Polak et. al., "Balance of Payments Problems of Developing Countries (Group of Thirty, New York, 1981), pp. 10–11.

The best way to view the vulnerability of the financial system to LDC debt is as a low-probability but high-cost event. It is unlikely that a rash of defaults will occur; it is unlikely that an international financial collapse will occur; but the costs of such an event would be so high that there must be close attention to LDC debt and adequate emergency measures.

LDC Growth and Adequacy of Financing Mechanisms

The likely debt problem is not that defaults might cause a global financial crisis, but rather that financing limitations and weak export markets may force many developing countries to reduce their growth rates in an effort to reduce their import bills. The result of a generalized slowdown in LDC growth would be hardship in the South and resultant, modest slow-downs in the North, as industrial countries found export markets stagnating in developing countries.

The international economic environment is a major source of the debt problem of the developing countries. The OPEC surplus of over $100 billion annually requires as its mirror image an aggregate current account deficit of comparable size for the rest of the world. In 1980 the industrial countries carried approximately $50 billion of this deficit and the non-oil developing countries $70 billion. Because of slower economic growth expected for industrial countries in 1981, this year the division will be an expected $20 billion for the industrial countries and $76 billion for the non-oil developing countries.[4] In other words, two major forces beyond the control of developing countries are causing the bulk of their international financial problems today: the OPEC oil price increase of 1979–80 and (to a lesser extent) the slow pace of economic activity and export markets in the industrial countries.

Against this background, LDC debt and growth may be analysed for two sharply different groups of countries; low-income (primarily in Asia and Africa) and middle-income (primarily in Latin America and East Asia).

For the low income countries the problem is best seen not as too much debt, but too little economic assistance. World Bank forecasts for this group range from disastrous to dismal, and their need for more aid is severe. Yet the Reagan budget cuts economic assistance by nearly one-fourth from projected levels. U.S. concessional assistance has fallen by 40 percent in absolute real terms since the early 1960's; and today, giving only 0.2 percent of its GNP in economic aid, the U.S. ranks 15th out of 17 industrial country donors in aid-giving effort. When considerations of long run national security are added to humanitarian concern, it could be an error in national priorities to slash foreign economic assistance in the general rush to cut the budget.

It is the middle-income countries, however, that account for the bulk of external debt and rely on the network of private financing and official financial assistance at market related terms. Several major problems face the process of growth and external financing for these countries, as enumerated below.

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[4] On goods, services, and private transfers. International Monetary Fund, Annual Report, 1980, p. 17, and OECD, Economic Outlook Dec. 28, 1980, p. 55.

Limits on bank lending

The private commercial banks face limits on the future lending they can provide developing countries. After the first oil shock, these banks filled the gap in LDC financing by sharply increasing their lending relative to that from official sources. Today, as a result, many banks are "lent-up" to developing countries. They face legal limitations (only 10 percent of capital may be loaned to one borrower), capital limitations, and limitations placed by prudence in light of their already high exposures in these countries. From 1974 to 1977, LDC loans as a share of assets for U.S. banks grew from 6 to 9 percent. By 1978–79, U.S. banks began to slow the pace of expansion of these loans (as the share fell to 8.4 percent), although Japanese and European banks took up the slack.[5] Now the prospects are for much slower growth of Japanese and European lending as well. In short, the private banks cannot be counted upon once again to bear the primary financing response that they provided after the 1974 oil shock.

OPEC surplus lingering

From 1974 to 1978 the OPEC surplus fell from approximately $68 billion to only $5 billion. This time the surplus is likely to last much longer. Imports of OPEC countries are already high, and the risks of social strains of rapid economic growth, shown by the turmoil in Iran, are recognized; imports are not likely to expand at rates comparable to those of the 1970's.

LDC indebtedness

The developing countries have already piled up large debts, and most will not be able to rely upon borrowing as much as they did after the first oil shock to continue rapid growth despite high oil import bills. Brazil is a major example.

Interruptibility

In these circumstances, one of the greatest dangers for a developing country is that new private lending may decline if creditors consider the country's prospects to have turned sour. External borrowing is like bicycle riding; it works relatively smoothly as long as it goes forward on its own momentum. But if there is a sudden braking, its balance is upset and the bicycle may fall over. Countries such as Brazil now rely heavily on continued (and growing) new lending, and they are vulnerable to any interruption of that lending, which would bring a liquidity crisis.

High and fluctuating interest rates

Today most LDC debt pays interest on the basis of a floating interest rate that rises and falls with international capital market conditions. The high interest rates of 1980 were a severe blow to many LDCs. A swing of 1 percentage point in the interest rate can cost the LDCs on the order of $2 billion in debt servicing charges. Even after allowing for increased interest earnings on foreign exchange reserves, the extra cost is approximately $1.5 billion per percentage point.[5a]

[5] Volcker, "Recycling . . . ," p. 8.

[5a] Gross external debt subject to variable interest rates is approximately $200 billion for developing countries excluding capital-surplus OPEC countries. Their external reserves excluding gold are approximately $80 billion. Assuming two-thirds of these reserves are in interest-sensitive assets, the net effect of a 1 percent rise in interest rates is approximately $1.5 billion in additional cost to the LDC's. (Source: World Bank, World Debt Tables, 1980; International Financial Statistics.)

The adverse effects of higher interest rates are probably even larger since they tend to depress commodity prices as it becomes more costly to hold inventories; moreover, higher interest rates stimulate increased capital flight from developing countries as private citizens place more funds abroad.

Macroeconomic policy in the United States appears to have been the main cause of high international interest rates in 1981. Throughout most of the 1970's U.S. interest rates (on Treasury bills) were approximately equal to (or lower than) the rate of inflation (consumer prices), and the Eurodollar interest rate averaged approximately 1.2 times the U.S. Treasury bill rate. In 1981, tight monetary policy and loose fiscal policy have driven the interest rate approximately 5 percentage points above the inflation rate (14.6 percent and 10 percent, respectively, for the first 6 months), and the Eurodollar rate has been driven up correspondingly (to 16.9 percent).[6] Broadly, U.S. macroeconomic policies appear to be responsible for a rise of about 5 percentage points in international interest rates in 1981. As a result, the developing countries have had to pay as much as $7 billion in additional interest on external debt this year, net of increased earnings on reserves. This extra debt servicing burden is equivalent to the cost to developing countries of a $7 per-barrel rise in the price of oil.

Export markets

The export prospects for developing countries are less than impressive. Slow growth in the OECD countries is currently hampering LDC exports. In the longer run, export growth is essential if the developing countries are to honor the payment of their external debt. Korea, Taiwan, and others have demonstrated that a concentrated export effort can pay off handsomely. Nevertheless, export opportunities are likely to be weakened by what appears to be a long period of relatively slow future growth in industrial countries.

Protectionism

LDC exports are also jeopardized by the possibility that industrial countries will restrict imports of LDC products. The multifibers agreement seems likely to be renewed on a restrictive basis; existing protection limits LDC export prospects for footwear, television sets, ships and steel. To be sure, the Tokyo Round of trade negotiations also opened up export opportunities, but the threat of protectionism in industrial countries hangs heavily over the prospects for LDC export growth.

Slower LDC Growth

The net result of all of these factors is that there are strong forces in the world economy today working to force developing countries to reduce their growth rates. Limitations on external financing and on export markets mean that many have no alternative to reducing growth in order to cut down on import spending. That result would be harmful for both North and South. If developing countries are forced to grow more slowly, they will buy fewer exports from the industrial countries. Today the developing countries account for approximately 40 percent of U.S. exports, representing close to 2 million American jobs.

[6] International Financial Statistics, various issues, and Survey of Current Business, July 1981.

Slower LDC growth will mean stagnation of these exports and job opportunities.

In more global terms, if the LDCs are forced to adjust to the OPEC surplus by cutting growth and imports, there will be a world-wide recessionary pressure. In the face of a persistent OPEC surplus there must be a persistent deficit carried by other countries. Attempts by individual countries to cut their deficits through reduced imports will shift the deficit to others; a chain reaction would induce a world recession.

Implications for U.S. Policy

The analysis set forth above suggests that there may be growing problems with international financing as the OPEC surplus persists, private bank financing to LDC's grows more slowly, and export markets for LDC's lose their buoyancy of earlier decades. The United States has a large stake in ensuring that financial mechanisms are both sound and adequate to prevent a wide-spread cutback in LDC growth. Specific areas for action include the following:

Aid to low income countries

In light of the problems for the United States posed by the LDC debt situation, the Reagan Administration may want to review its recent decisions on foreign aid. The Reagan budget cuts back future growth of aid, cuts the real level of the development portion of aid by 10 percent and then projects no real growth at all in this level through 1986. Even the achievement of this aid effort is subject to doubt, because the budget delays much of the IDA outlay until fiscal year 1983, providing an easy target for Congressional cutting that year.

World bank and IMF

The United States and other members of the World Bank have agreed to double its capital from $40 billion to $80 billion. This measure will help meet financing needs of middle income countries.

The United States should also give careful consideration to the proposal (by the Brandt Commission) to double the "gearing ratio" of World Bank loans to capital. If the financial markets consider this measure to be feasible without significant erosion of the credit standing of the World Bank, it would very substantially ease the credit crunch for the developing countries. Alternatively, the same effect could be accomplished by approving an increase in World Bank capital without having any portion of the increase be in paid-in capital.

The International Monetary Fund is another essential vehicle for LDC financing. The decision of the IMF to use direct borrowings from the capital market, if necessary, expands the Fund's ability to meet financing needs of developing countries. Sizeable recent increases in IMF quotas, and in the amounts member countries can borrow relative to quotas, have substantially increased the IMF's financing capacity, but it is necessary to review the adequacy of that capacity.

One idea that warrants consideration is to widen the concept of IMF compensatory financing to include not only financing to cover losses from declining commodity export prices, but also the increased debt

servicing needs caused by interest rate fluctuations. If new monetary strategies in the United States and other industrial countries cause higher and fluctuating interest rates, a case can be made for providing a new window at the IMF for compensating loans to offset surges in interest payment obligations, much as is now done for export shortfalls.

OPEC lending

There is a strong case for increased direct lending by surplus OPEC countries to developing countries. Because the capacity of private banks to act as intermediaries has already been stretched thin, it is important that funds of surplus OPEC countries more and more flow directly to LDC's.

The United States might explore ways of encouraging increased OPEC lending to the LDC's. One possibility would be for the United States (and other industrial nations) to provide new, improved financial assets (such as bonds indexed against inflation) for OPEC countries to hold, and to make these assets available for OPEC to purchase on a matching basis, such as $1 billion of such assets for each extra $1 billion that OPEC lends directly to developing countries. Such a mechanism could help induce OPEC to produce more oil (as the real rate of return on assets turned positive, making them more competitive with oil held in the ground), as well as increase the adequacy of financial recycling of the OPEC surplus.

Conclusion

The United States has a major stake in the orderly functioning of the international financial and recycling system. At present there is strain, but little apparent danger of imminent collapse of this system. The greater danger is that there will be a torturous reduction in long-run growth rates of developing countries because of limited external financial flows to them. The price of slower growth in the Third World would be greater human hardship, more stagnant future markets for U.S. exports, and the risk of increased political instability.

TABLE 1.—INDICATORS OF EXTERNAL DEBT AND CREDIT-WORTHINESS: NON-OIL DEVELOPING COUNTRIES,[1] 1973–80

	1973	1974	1975	1976	1977	1978	1979	1980
Public and publicly guaranteed debt (billions)	$76	$95	$115	$139	$172	$212	$246	$280
Percentage by source:								
Official	64.5	63.2	60.9	58.3	55.2	52.8	52.0	52.5
Private	35.5	36.8	39.1	41.7	44.8	47.2	48.0	47.5
Ratio: Debt/exports of goods and services	0.70	0.64	0.76	0.78	0.82	0.86	0.80	0.74
Current account deficit as a percentage of exports of goods and services	10.4	24.8	30.4	18.1	13.3	14.7	17.9	18.0

[1] Includes Mexico.

Source: International Monetary Fund, "World Economic Outlook," May 1980.

EXTERNAL DEBT AND DEBT SERVICE RATIOS, MAJOR DEBTOR COUNTRIES

Country	External debt,[1] end 1979 (billions)	Debt service as percentage of exports of goods and services [1]	
		1973	1979
Brazil	[2] $52.3	[2 3] 36.0	[2] 61.1
Mexico	28.8	22.2	64.1
India	15.5	18.7	[4] 9.9
Korea	14.7	15.3	14.0
Algeria	15.3	12.2	25.6
Indonesia	13.3	6.3	13.4
Egypt	11.3	40.2	15.8
Turkey	11.0	6.8	13.9
Israel	10.0	16.0	10.3
Venezuela	9.8	6.0	9.4
Spain	8.7	3.3	[4] 10.1
Argentina	8.1	17.9	16.8
Pakistan	8.0	14.7	12.2
Philippines	[2] 7.4	8.7	23.2
Morocco	6.2	8.3	[4] 18.7
Peru	6.0	30.4	31.6
Chile	[2] 5.0	[2 3] 18.2	39.2
Zaire	3.8	8.5	10.4
Nigeria	3.7	4.0	1.5
Yugoslavia	3.7	5.4	[4] 3.4
Portugal	3.7	[2 3] 4.8	[2 4] 12.3

[1] Public and publicly guaranteed debt.
[2] Including nonguaranteed private debt.
[3] 1974.
[4] 1978.

Source: World Bank, "World Debt Tables," EC-167/80, vol. I, EC-167/79/S-3.

DEVELOPING COUNTRIES

U.S. POLICY TOWARDS THE SOUTH: ONE PART SHADOW, ONE PART SUBSTANCE

By Sidney Weintraub*

A favorite word to describe the state of North-South (developed-developing country) relations is impasse. It was precisely to break a perceived deadlock that Robert McNamara, President of the World Bank, stimulated the appointment of the Brandt Commission. In a recent article in *Foreign Affairs*, Roger Hansen refers to the situation as "stalemate," and he blames this mostly on the United States and other industrialized countries for resisting international structural reforms (he calls it "stonewalling"), and not coming forth with an agenda of their own.[1]

The argument of this paper is that impasse (deadlock, stalemate), or more accurately, confrontation, is the normal state of affairs when one side, the South, seeks unrequited benefits and a concessional grant of power. This is not a hopeless situation since the South does benefit from the current international structure, but in increments and not grand gestures. The cumulation of these benefits can be significant, as is evident from the economic growth rates of middle-income developing countries over the past quarter century; these have been higher than for the industrialized countries, indeed higher for a significant group of countries over a longer period than ever occurred before in recorded history.[2]

This paper deals with four themes. First, why should we care about the state of our relations with developing countries? Second, how are North-South issues negotiated in global forums? Third, what are the competing agendas of the North and the South? Fourth, how should we conduct our policy and how should we react to the more sweeping demands put to us under the rubric of the "new international economic order"? The report of the Brandt Commission will be discussed separately because it spans all these themes.[3]

Why We Care

Our relations with developing countries are guided by a mixture of self interest and unselfish concern. It is too simple in defining these

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[1] Roger D. Hansen, "North-South Policy—What is the Problem?" Foreign Affairs, vol. 58:5 (Summer 1980), 1104–28.

[2] Growth data can be found in each of the three World Development Reports (1978, 1979, and 1980) of the World Bank and in David Morawetz, "Twenty-five Years of Economic Development, 1950–1975" (Baltimore, Md.: Johns Hopkins University Press, 1978).

[3] "North-South: A Program for Survival," the Report of the Independent Commission on International Development Issues under the Chairmanship of Willy Brandt (Cambridge, Mass.: MIT Press, 1980).

relations to lump together all developing countries since our interests and our concerns vary by degree of development, location of strategic minerals, and probability of transmitting turmoil back to us. Soviet hegemony in Cuba or elsewhere in the Caribbean or Central America is more menacing to U.S. security than is Soviet hegemony in Bulgaria. War in the Middle East, bringing on trade disruption, would affect our well being more than past wars did in South Asia. Boat people come to our shores from Haiti because of economic hardship, but not from Bangladesh.

It is not overstatement to assert that the lives of future generations of Americans will be deeply influenced by what happens in developing countries, since this will determine the population of the earth, the use of resources, and the contamination of the environment. Issues of war and peace for Americans may depend on developments in developing countries.

We care about the current condition of developing countries because economic health, like stagnation, is contagious. The most significant external determinants of our trade are the economic size and the growth taking place in our markets. In 1979, one-third of our merchandise exports went to developing countries, including OPEC countries. Of this, more than 90 percent (more than $60 billion) went to middle-income as opposed to low-income developing countries. One vivid illustration of the importance of affluence as a determinant of U.S. export sales is that U.S. exports in relation to the Canadian population were $1,400 per capita in 1979 in contrast to $55 per capita to Columbia and $4 per capita to Zaire. The three countries have roughly the same size population, but one is industrialized, one middle income, and one low income. Most U.S. direct investment overseas is in industrialized countries, but of that in developing countries, about 90 percent was in middle-income countries at the end of 1978.

In addition to petroleum, developing countries are important suppliers of such minerals as bauxite, manganese, phosphate, cobalt, tin, tungsten and copper.

The variety of justifications given for our aid programs demonstrates the mixture of motives for seeking cooperative relations with developing countries. The motive is often self-interest. Secretary of State Muskie stressed the great power and war and peace themes in a speech:[4]

> Declining American aid, and declining American influence, would also help the Soviets exploit internal instability. In Nicaragua, in El Salvador, and in many other places, the Soviets are prepared to exploit tensions to expand their power and to limit Western influence. Finally, the decline of American aid and influence would hamper our efforts to settle dangerous disputes and build peaceful solutions.

Former Secretary of State Vance played on this same theme, that "it is the Third World . . . that is likely to be the cockpit of crises in the coming decade." But he also added a less self-interested rationale: "Support for the political independence and economic growth of the poorer nations is important primarily because these nations matter in their own right."[5]

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[4] Speech to the Foreign Policy Association, New York, July 7, 1980, New York Times, July 8, 1980, p. A4.

[5] Harvard class of 1980 commencement speech. Harvard Magazine, vol. 82:6 (July-August 1980), p. 68.

The clearest expression of the moral foundation of concessional aid is the stress in the program on meeting basic human needs of the people in the world's poorest countries. The size of the U.S. aid program in Bangladesh can be explained only on these altruistic grounds.

We care in different countries for different reasons. The intensity of our concern—a proportionality principle—explains the larger levels of aid to Israel and Egypt than, say, to Africa south of the Sahara. Our economic relations with, say, Brazil, Mexico, and South Korea are dominated by trade and investment, and in the poor countries of Africa and Central America, by aid. This need to differentiate among policies and in proportionality of policy use is one reason why global negotiations in the U.N. (North-South) framework are so unsatisfactory. They do not permit this differentiation.

The Nature of North-South Negotiations

The most important tactic of the South in North-South or global negotiations is to bargain from a position of unity. This unity may have been the most significant result of the first United Nations Conference on Trade and Development (UNCTAD) in 1964, when the Group of 77 developing nations (now about 125) emerged as a force in the United Nations. The Group of 77 became the economic counterpart of the Non-Aligned Movement. In addition, UNCTAD–I reinforced the practice of bloc negotiation in the UN system. Groups other than the Group of 77 also try to coordinate positions, but the focus is different. The Communist countries speak with a single voice but thus far they have been irrelevant in the North-South negotiations. Their standard speech states that they did not cause the troubles of the developing countries and therefore have no responsibility to rectify them. The industrialized countries caucus in order to respond in a uniform way to the demands of the Group of 77, but this rarely succeeds. It is this reactive posture of the industrialized countries that is often criticized on the grounds that the North should take the initiative with an agenda of its own. This charge misreads the process and the simple counter to this criticism is that the North does have its own agenda, played out not just in the UN General Assembly or UNCTAD, but in many functional bodies. It is precisely this agenda that the South is trying to alter.

The unity of the South has been compared to a labor union. Countervailing power is needed, it is argued, in order for weaker nations to achieve their objectives in dealings with more powerful nations. A more apt comparison would be to look on the Group of 77 as a federation of many labor unions, some craft and some industrial, some well entrenched and others just seeking recognition, trying to obtain concessions not from just one plant or even industry, but across the entire spectrum of the economy. Non-comparable nations in the South seek to negotiate—if that is the right word—on a common agenda with non-comparable nations in the North. This can be done only if the demands include something for everybody. Some countries in the South want concessions for their trade in manufactured goods while others have no manufactured goods to sell. Some want debt relief and others want to retain their credit ratings. Some want more concessional aid while others seek capital on commercial terms to finance their development. The agenda of demands, such as the program of

action put forward in the United Nations to carry out a new international economic order, reflects these disparities.

Thus, the South can jointly demand more concessional aid, for while the poorer developing countries would be the beneficiaries, the richer would not be hurt. The richer developing countries benefit more from trade concessions from the North, but the poorer are not hurt. Demands are more complicated to formulate when some countries' interests are damaged. This explains the ambiguity over demands for debt rescheduling. At times, this sort of log-rolling (country A will accede to country B's demand if B in turn accedes to A's) is not possible—as with oil prices—and unity is reached by omission.

This potpourri of demands does not state what the Group of 77 will offer in return. If Sri Lanka makes demands for, say, more aid or higher tea prices, it really has nothing tangible to offer in return. As one moves up the development ladder, more reciprocity is possible. Mexico or Yugoslavia may not be able (or may not wish) to offer equivalence for the trade concessions they receive, but they do have markets and it is not unreasonable for the North to ask for something in return. But it is difficult in a collective negotiation with the Group of 77 to obtain different concessions from different countries. Nonreciprocity is a useful slogan, but it breaks down if it requires treating Brazil and Chad alike.

It is hard to delineate quid pro quos in such a global, multi-functional framework since any specific concession that might be obtained will usually benefit only some of the developing countries. One illustration of this is that five developing countries shipped 68 percent of the goods which entered the United States in 1978 under the general system of preferences (GSP); the 15 leading country suppliers shipped 90 percent. The other 100 plus countries were marginal beneficiaries or benefited not at all.[6]

It does not take much insight to see that if significant concessions are demanded as a matter of right and no consideration is offered in return, this generally involves something more than a polite request. It requires confrontation. The labor union analogy is apt here. It takes countervailing power to obtain concessions that go beyond tokenism.

This troubles many Americans, and we have our own slogan: "negotiation, not confrontation." Negotiation normally entails give and take, and the parties each obtain some rights but also give up something, although the exchange among the parties need not be equivalent. When there are one-sided concessions, these can come as a self-stimulated act of grace (which occurs from time to time, as in disaster relief programs) or can be extracted by confrontation. If the purpose were to negotiate mutual concessions in the same field, this would be hard to accomplish in a multifunctional forum like the UN General Assembly. This helps explain why the United States prefers to negotiate on precise issues in functional bodies and why the Group of 77 prefers to confront in global, multi-functional UN bodies.

No one should be in any doubt, either, but that this type of confrontation works. Not in all cases, but often. It is even possible to set forth a prototype pattern that may vary in its details in each case

[6] "Report to the Congress on the First Five Years' Operation of the U.S. Generalized System of Preferences," House Committee on Ways and Means, 96 Congress, 2d session (GPO, 1980), p. 41.

but which is generally consistent: demand by the South; stonewalling by the United States or the North generally; persistence by the South; weakening in the North under which the idea behind the request is accepted "in principle"; then a negotiation to reach agreement on the details; and, finally, a concession is granted, one not precisely what was sought but still a major departure from the original categorical rejection by the North. This pattern fits the United States better than it does most other industrialized countries.

Many examples can be given to document the pattern. The principal concession sought by the Group of 77 at UNCTAD–I was preferential entry into the markets of the industrialized countries for their exports of manufactures and semimanufactures. The almost universal initial response was an emphatic "no." Then, slowly, individual and groups of industrialized countries relented and over time general systems of preferences were instituted and later legitimized in the articles of the General Agreement on Tariffs and Trade (GATT). The U.S. GSP went into effect in 1976, some 12 years after the pressure started. In no case was the grant of preferences without safeguard for the granting industrialized country and in many cases it was accompanied by quota restrictions that made the value of the grant questionable. The pattern, however, was classic.

Another classic example is the common fund for the financing of buffer stocks designed to stabilize earnings from the export of primary commodities. The U.S. position went from no, to let's talk, to yes "in principle," and finally to yes, but in a form much diluted from the original formulation. Non-reciprocity by developing countries in trade negotiations with industrialized countries was enshrined in the GATT; the compensatory finance facility of the International Monetary Fund (IMF) was instituted and successively improved; and the harshness of conditionality by the IMF (the imposing of conditions on economic policy in exchange for borrowings from the IMF) was successively eased. Some of these changes might have come about without pressure and confrontation, but the evidence is that they in fact came only after repeated demands made by the unified group of developing countries. One can argue whether the opportunity cost of obtaining these concessions was too high (e.g., whether GSP impeded general tariff reductions on a most-favored-nation basis), but this really is unknowable. One can quarrel whether the developing countries demanded the correct concessions, but this does not contradict the thesis that confrontation usually is necessary for the weak to obtain significant concessions from the strong.

The process has no logical ending point as long as some countries are relatively rich and others relatively poor. A concession does not beget tranquility; it is prelude to the next demand. An initiative by the industrialized countries will not change the process; if satisfactory, the initiative will be accepted, and the process will continue. One weakness of the process is that it has poisoned the atmosphere of North-South meetings. Nevertheless, it is a normal process and need not be the cause of excessive handwringing.

One other fact worth mentioning is that the most significant concessions obtained have benefited the better-off of the developing countries. This already has been noted for GSP. Unity of the developing countries does not lead to uniform benefits for all of them.

There are some concessions that have not been granted despite intense pressure. These deal with possible fundamental alteration of the international economic system or the transference of power for decision-making from the industrialized countries to the Group of 77, or more precisely, to the more powerful countries of this Group. These are discussed in the next section.

One change sought in the North-South framework that appeared likely to follow the classic pattern but which did not was the demand for a link between the issuance of Special Drawing Rights by the IMF and resource transfers (aid) to developing countries. There are many variants of the link, but in essence it involves distributing newly created SDRs not on the basis of country quotas in the IMF (under which the industrialized countries receive about 70 percent of SDR allocations), but some other formula that would favor the developing countries. The resistance to the link has come mostly from the United States and Germany and thus far they have carried the day—but the issue is not yet dead.

The Competing Agendas

The agenda of the industrialized countries is quite different from that of the developing countries. These competing agendas get to the nub of the international debate.

The international economic order espoused by the industrialized countries operates under a set of principles accepted by them and codified in various international agreements, such as the GATT, the IMF, and the World Bank, and which get their vitality by practices which have grown up.[7] It is not unlike the U.S. Constitution in this respect, and like the Constitution, amendments are not accepted frivolously. Fundamental elements of the system include: nondiscrimination in trade as a general rule, with departures permitted only under prescribed conditions (as for customs unions or free-trade areas, and, a more recent amendment, for GSP in favor of developing countries); the use of tariffs as the preferred protective device for domestic industries, rather than nontariff measures (although, now that tariff levels are low in the industrialized countries, codes are being tested for making non-tariff measures more transparent and, over time, more difficult to use); a preference for private capital transfers over public means, but without eschewing supplemental public transfers for those countries unable to attract sufficient private capital on acceptable terms; donor control over the provision of the bulk of foreign aid; conditionality in IMF financing (although less stringent than in the past); and weighted voting (control by industrial countries) in the financial institutions. Many of these principles have been nibbled down, but not away, as the result of changed circumstances and specific concessions granted by the North.

The agenda flowing from these principles has included the progressive reduction of tariff barriers on a most-favored-nation basis and, as noted, an attack on non-tariff barriers; prevention of measures such as subsidies or undervalued exchange rates to seek unfair advantages in trade; progressively seeking maximum freedom for capital move-

[7] In this regard, see Joseph Gold, "The Rule of Law in the International Monetary Fund" (Washington, D.C.: IMF, 1980).

ments among countries and diminution of artificial incentives by countries to attract capital; the provision of resources, bilaterally and through multilateral development banks, to augment private capital movement in support of development programs; and steady growth in IMF resources commensurate with the increase in international trade and with the need to augment balance-of-payments support because of changed circumstances resulting from oil price increases. The agenda is sometimes honored in the breach, but by and large the direction of international economic policy of the North has been faithful to this agenda since World War II. The system was shaken by a shift from fixed to flexible exchange rates, but this is less fundamental than the avoidance of measures to use exchange rates to the detriment of others. The system was shaken even more profoundly by the substantial real increases in oil prices in 1973–74 and again in 1979–80. It did not collapse after the first oil price increases, as many believed it would because they doubted that funds could be recycled to where they were needed, but the price increases did reshape the structure of balance-of-payments financing. The 1979–80 oil price increases have further complicated the financing problem but it seems likely that the system will again cope by expanding both official and private financing levels.

The allegation that lies behind the call for a new international economic order is that this system and its agenda have been detrimental to the well-being of developing countries. The evidence belies the charge. Using data from the World Bank, the weighted average for annual growth in GNP per capita from 1960–1978 in the middle-income developing countries (those with per capita income above $360 in 1978 and having close to one billion people) was 3.7 percent. As noted earlier, this is remarkable growth over such a sustained period. For the low-income countries (those with per capita income of less than $360 in 1978, and having more than one billion people, excluding China), the growth rate was significantly lower, at 1.6 percent—not atrocious by historical standards, but not good by modern standards. The countries that did most poorly were in Africa and Bangladesh. Export data show an even more disparate picture, of substantial volume growth for middle-income countries and more modest growth for low-income countries (indeed, a decline for 1970–78 for the latter group). It already has been noted that the concessions granted from the North-South confrontational process have not substantially benefited these poor countries. The root cause of their problem is not post-World War II international-systemic; it is internal-systemic. Those countries able to take advantage of the current system have done so, often spectacularly. Those unable to do so need aid in order to take advantage of any system.

It is not just in income and trade growth that the figures belie the charge of systemic damage to developing countries, but also in indicators of the quality of life. Life expectancy has increased in all groups of developing countries, infant mortality has decreased, and school enrollments are higher as a percentage of the age group. The same disparities, however, can be found between groups of countries. For example, in 1978, life expectancy at birth was 50 years in low-income countries, 61 in middle-income countries, and 74 in industrialized countries.[8]

[8] Data cited are from the World Development Report, 1980.

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The South, as revealed in various resolutions relating to a new international economic order, starts from a different set of premises. The most important of these are: decision-making in the significant international organizations (the IMF, GATT, the World Bank) must be altered to give them more, and eventually controlling, authority (or, failing this, move more decision-making for the international economy to UN bodies, where they exercise control); systematically alter the principle of non-discrimination to provide special and differential treatment for developing countries, not just in tariff matters but across-the-board on economic isues; and make aid-giving more automatic, that is, remove allocation control and determination of conditionality from the donor countries.

There is ample scope for compromise between the competing agendas of the North and the South at the level of specific concessions. The changes cited earlier that have come about as the result of pressure from the South, or because international economic circumstances have changed, demonstrate this.

There is less scope for compromise on the issue of power—of who controls the system. It was precisely such a conflict over institutional supremacy between the so-called Committee of the Whole in the United Nations (where the developing countries have control) and key functional bodies such as the IMF, World Bank, and GATT (where, by and large, developed countries maintain control) that could not be resolved in the September 1980 special session of the UN General Assembly. It goes almost without saying that the countries of the North would not leave the workings of the international monetary system, or the principles guiding international trade, to the tender mercies of UN resolutions—or to its equivalent, a controlling voice for developing countries in critical functional institutions such as the IMF. If decision-making in the IMF became like decision-making in the General Assembly, the countries of the North would form a new monetary institution which they controlled.

A Feasible U.S. Policy Approach

The United States can cope best with unacceptable demands if its actions do not contradict its stated principles.

The most serious example of such a contradiction is protectionism which, while not rampant, is growing. Some import restrictions can be justified in economic theory and political realities especially if they are temporary. Nevertheless, protectionism strikes with most force against middle-income countries. While these countries may criticize the present order in UN forums, they must certainly know that they have benefitted most from it and would not want to alter it in its fundamentals. Specific instances of U.S. protectionism are limits on imports of products (or forced "voluntary" restraints by exporters) for which developing countries have a comparative advantage (such as apparel, shoes, television sets, and meat) and the threat of restrictions on products in which these countries are developing a competitive position (such as steel). Other countries of the North have similar restrictions on these and other products (such as shipbuilding). It is hard to believe that the countries of the North would allow their protectionism to become pervasive since this would jeopardize the prosperity so painstakingly built up in the period since World War II. However, it

would not take too many permanent departures from the concept we say we espouse, of gradually dismantling trade barriers, to call into question the durability of the whole structure. Protectionism is the kind of disease that spreads from country to country.

If the United States wishes to carry the argument of donor control over the provision of concessional aid resources, these must be provided in adequate volume. In the speech cited earlier, ex-Secretary of State Vance called the U.S. aid performance "disgraceful." Our concessional aid was 0.19 percent of GNP in 1979, which tied us for the next to last place among the 17 countries of the Development Assistance Committee.[9] The critical aspect is not the precise GNP ratio, since the 0.7 percent target has few adherents among responsible U.S. officials, but the fact that we are doing less and less almost every year. After correcting for inflation, the U.S. aid volume was lower in 1979 than it was in 1970. The United States has been in arrears almost constantly in recent years on its pledges to multilateral development banks because of lags in Congressional appropriations.

It was noted above that one tenet of U.S. aid policy was to control the allocation of its own concessional aid. This principle already has been breached in its pure form by the provision of concessional resources to multilateral development banks and other international agencies for further allocation by these institutions. This comprises about a third of U.S. concessional aid. It may be possible to further modify this principle to the extent that additional resources (or claims on resources) are generated by international (as opposed to national) activities. The SDR-aid link may be such an example, or funds generated from future seabed mining, or profits from the sale of IMF-held gold. These are not suggested to finesse the appropriation process by the Congress. Rather, the Congress could make explicit delegations of authority to the Executive Branch to provide resources under precisely defined conditions. There is precedent for this in the trade field in which similar delegations have been provided periodically since the reciprocal trade agreements program of the 1930s. It is unlikely that funds so generated would be sufficient in the foreseeable future to meet all calls on the United States for funding the international financial institutions. These delegations need not affect selection of recipients or the Congressional authorization/appropriations process for bilateral aid. They would not affect the bulk of U.S. aid.

What would not be acceptable in the United States is a complete breaching of the principle of donor control over the provision and destination of the major part of U.S. aid. The suggestion often is motivated by the desire to bypass the Congress. If the United States must tax itself for ongoing activities in order to provide aid, it is hard to see the Congress giving up its involvement in the authorization/appropriation process. For this reason, it is futile to expect that the revenues from import duties can be allocated automatically for foreign aid, as suggested by the Brandt Commission and others. This would amount to automatic earmarking of a domestic tax, and it is hard to believe that Congress would sacrifice its appropriation discretion for the benefit of foreign countries.

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[9] Organization for Economic Cooperation and Development, press release on "Resources for developing countries 1979 and recent trends," Paris, June 19, 1980.

There are other actions the United States can take that are consistent with its philosophy of international economic interchange. These include efforts to augment world food security and to encourage greater exploration and innovation for conventional and non-conventional energy sources. Some of these steps are being pursued.

However, the crux of the demands from the South have less to do with these substantive issues, as important as they are, than with structural reform. There is no easy way to satisfy this demand short of capitulation, nor, indeed, has a persuasive case been made that it should be satisfied. It can not be satisfied merely by increasing the proportional vote of countries of the South in the functional economic institutions, since this has been done periodically in recent years without settling the issue. What is being demanded is more inclusive, namely, parity or control by developing countries. The argument in favor of such a radical change is that the world has changed radically since the central institutions were created at the end of World War II and that what was devised then by a few western countries no longer fits the circumstances of the current decade. This transformation in shift of control already has occurred in the UN General Assembly, and, so the argument goes, there is no reason in equity why a similar transformation should not take place in the IMF, GATT, and development banks.

There is a difference, of course, between institutions which are predominantly forums for debate and passing resolutions and those in which decisions lead to actions that affect national incomes and employment. This is so widely recognized that many persons who support drastic structural change in the management of the functional institutions assert that their management would continue to stress substantive economic considerations rather than political ones. Perhaps, but the evidence from the UN General Assembly is not convincing and too much is at stake to take such assertions on faith.

The most important prescription for U.S. international economic policy is not to panic in the face of political confrontation, but, at the same time, be true to its own principles.

Report of the Brandt Commission

The Brandt Commission report has attracted about as much attention in the United States as a UN resolution supporting the Third World position. There are many reasons for this. The public attitude in the United States is not favorable towards increased aid. However, some of the fault for the scant attention must be placed on the report itself. The report is not a documented presentation, but rather an extended essay (at times eloquent, at other times reading like a UN resolution) in favor of Third World positions. The report is typical of documents coming from the South in its lack of distinction among Third World countries. Unity of the South is taken as supreme, and there is a plethora of recommendations to accommodate all countries of the South so that the unity need not be shattered.

The report is a reasonably faithful recitation of the agenda of the South without much consideration of why the North behaves as it does. This stems both from the commissioners selected and the terms of reference under which they operated. These contain the following admonition: "The need for a new international economic order will be at the center of the Commission's concerns." The terms of reference

and the report itself tend to be patronizing both to public opinion and decision-makers in the North since the consistent burden of the presentation is that the problem of promoting mutual North-South interests is largely one of education in the North. If only the decision-makers in the North knew better, the world could be transformed.

The report contains practically no discussion of the economic progress of the South under the current system. Its central theme is the need for "long-term actions to turn round the world economy." Even when discussing the proposed summit meeting of world leaders to give impetus to an emergency program for 1980–85, the report stresses the need to keep this long-term structural emphasis in mind.

There are many emphases in the report which are unexceptionable, such as the focus on the mutuality of interests between the countries of the North and the South, on the need for measures to increase food production and to control population growth. There are many recommendations which are valuable, although few, if any, of these are original and many are being carried out. Among the latter are: providing more financial assistance to developing countries for energy development; extending the scope of the IMF compensatory finance facility; increasing program lending by the World Bank; and augmenting international efforts to develop appropriate technology for developing countries. Some recommendations appear meaningless: "the IMF should avoid inappropriate or excessive regulation of (developing country) economies, and should not impose highly deflationary measures as standard adjustment policy"; or "The time has come to examine whether a negotiating format can be devised which is more functional, while fully respecting the concerns of developing countries for maintaining their solidarity."

The real problem with the report, however, is the cavalier way with which it deals with the concerns of the North. The report advocates a massive transfer of resources to developing countries, devising mechanisms to raise most of this automatically, and at the same time altering power relationships in favor of the South in the aid-giving and other functional institutions. The exact size of the aid transfers advocated is not clear (although the report cites an econometric study, the details of which are not presented, on the effects of an increase in transfers of $20 billion a year), but does indicate that if the 0.7 percent target for official development assistance were reached in 1985, this would result in increased transfers then of $30 billion (in 1980 dollars). Several schemes are presented for raising funds automatically, but the one that is preferred is some form of progressive international taxation, such as a levy on international trade with some upward adjustment in the formula for countries with low ratios of trade relative to GNP (such as the United States and the Soviet Union). The combination of massive transfers, the amount to be determined to some extent by aid targets, achieved through automatic progressive taxation in the rich countries, and the sacrifice of authority by the aid donors in the use of funds so raised, is so breathtakingly contrary to what is possible in the large countries of the North (certainly in the United States), that these recommendations might well have been written by a visitor from Mars.

The justification for large-scale transfers is presented in terms of the self-interest of the industrialized countries. The argument is that large-scale transfers would stimulate employment and economic activity in the industrialized countries without generating inflation,

whereas allocating these resources directly at home would be inflationary. The argument is developed in a few sentences and is not at all clear.

The *ex gratia* cession of power to the developing countries is advocated on the grounds that it would increase the sensitivity of functional international organizations to the problems of the developing countries and also facilitate consensus building between the North and the South. But it is unrealistic to expect citizens in rich countries to tax themselves without regular review by their elected representatives for the benefit of citizens in poor countries. There are obvious reasons for this including the fact that some of the taxes would be paid by people poorer than those receiving the benefits.

There is much in the report that is useful, such as the discussion on the dangers of protectionism. But there is also much that is less than convincing, such as the many suggestions for institutional change (establishing a World Development Fund to distribute the large-scale transfers, merging UNCTAD and GATT with unspecified rules for the merged organization, and having a mechanism in the UN structure for overview of the functional institutions). The most serious criticism is that there is so much in the report that is either naive or downright insensitive about the reasons for positions taken in the North, that is is hard to take the report seriously as a basis for action.

Conclusions

Much of the confrontation that takes place in global North-South institutions, particularly those that cut across functional lines (such as the UN General Assembly and UNCTAD) is shadow boxing. Extreme positions are put forward by a unified South as part of a pressure process and these often lead ultimately to concessions by countries of the North, although much diluted from the original demands. The concessions granted are often beneficial to some countries of the South, usually the more economically advanced among them, but they are marginal to the fundamental developments taking place in the world economy. For example, the countries best able to take advantage of GSP systems in the North are able generally to exploit markets in the North with or without preferential treatment.

The more basic objective of the South deals not with these specific concessions, but with a shift in their favor in decision-making power in the most significant international economic institutions. This, like the search for power in other fields, is a never-ending process. The North has refused to grant this, except marginally, and is unlikely to cede such power voluntarily since this could affect fundamental outcomes in their economies rather than subsidiary ones. There was a shift in power during the 1970's in favor of OPEC countries, but this was not granted as an act of grace to achieve consensus, but was seized—and it has not led to consensus between oil exporters and oil importers.

The rationale given by those who seek to alter power relationships in international economic organizations is that the structure as devised prejudices the economic development of the countries of the South. The evidence does not support this contention—indeed, it can support the opposite conclusion, that the existing system has been kind to these countries and permitted unprecedented levels of sustained economic growth.

The guidance that this analysis provides for policy-makers in the United States is to expect confrontation from countries of the South as a normal condition and one that is not necessarily unhealthful for progress. Nations are prodded to change by forcing events and not by initiatives spontaneously generated from within their bureaucracies. Extreme or unreasonable demands can be rejected in an intellectually honest way, however, only if professed principles are adhered to in practice. It is a difference between preachment and practice which is most likely to bring down the international economic system so laboriously, and so profitably, constructed over the past 35 years. The dangers to this system lie in excessive protectionism and it can be argued, failure to provide adequate levels of concessional resources to countries unable as yet to take advantage of the international rules of the game in the market place. Protracted contraction of international trade, which protectionism would bring in its wake, would justify the call for structural change.

Many critics of the current structure deplore the incremental nature of changes that are effected. Nevertheless there have been changes—more special treatment of developing countries in the trading regime, greater flexibility in the assistance practices of the IMF, and increases in both regular and concessional resources of the multilateral development banks. Yet there is no alternative to incrementalism for a policy-maker in the United States. The international agenda changes constantly and the test of good policy is the efficiency with which positions can change in conformity with changing reality. There is much that must be done in the years ahead—particularly in such fields as energy, food production, population containment, education, employment—and most of these have little to do with the debates that take place in global North-South forums. The latter deal essentially with power while the agenda deals with internal and international policies.

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THE NEWLY INDUSTRIALIZING COUNTRIES: EXPERIENCE AND LESSONS

By Anne O. Krueger*

SUMMARY

The newly industrializing countries (NIC's) are a small group of export-oriented countries which have experienced very rapid rates of economic growth over the past decade. Among them are Brazil, Hong Kong, Singapore, South Korea and Taiwan. Although the characteristics of these countries differ in many regards, two sets of factors were very important for success of all five: The fact that they relied on export promotion and the international economy as a major source of expansion of their manufacturing and industrial sectors; and the fact that they were committed to achieving economic growth, and altered domestic policies accordingly. Prior receipt of American foreign aid was also important for Brazil, Korea and Taiwan.

The NIC's have demonstrated that poor countries can substantially transform their economies and alter economic prospects. They have also demonstrated that rapid growth can be consistent with rapidly rising living standards for the poorest segments of society. As such, their experience provides a basis for optimum about future prospects of developing countries whose governments are committed to raising living standards of the population.

There are a number of important lessons for American international economic policy:

Foreign aid is very important for very poor countries in order to permit enough capital formation and development so that an export orientation becomes possible.

After a period of time, aid can no longer be so valuable, while international trading opportunities become increasingly important. For middle income developing countries, access to international markets is vital for their growth prospects.

In switching to an export orientation, countries have found it politically easier to substitute fairly uniform export subsides for devaluation. When subsidies are fairly uniform across sectors, there should be no objection.

There does, however, need to be attention paid to developing criteria for graduation, including countries' opening of their own markets to foreign trade and switching from export subsidies to exchange rate realignment.

Reasonably open trade policies have been, and will continue to be, important for American economic well-being. The NIC's have constituted an increasingly important market for American exports. American concern with the impact of imports on employment has greatly

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overstated the probable impact, and ignored job creation in other sectors of the economy.

Introduction

During the 1950's and 1960's, it was sufficient to think in terms of a dichotomous world of developed and developing countries. To be sure, minor differences (such as ready availability of additional lands and size) were recognized, but these were secondary to the many attributes shared by all developing countries (then termed underdeveloped or less developed). A prominent, common attribute was that all were predominantly primary commodity producers. The manufacturing sectors were generally small, producing either handicraft products for the local market or else high-cost, low-quality products behind high walls of tariff protection and import prohibitions. Developing countries universally exported primary commodities and imported manufactured goods, and little thought was given to the notion that they might in the foreseeable future become competitive in manufacturing. As late as 1960, only 11 percent of developing countries' exports were manufactures and those were usually closely tied to the availability of a domestic raw material. Only 6 percent of world exports of manufactures originated in developing countries in that year.[1]

By the mid-1970's, there was a dawning realization that the situation had fundamentally altered: not only had the oil exporters' economies become sufficiently differentiated to be recognized as a distinct group, but a number of developing countries had emerged as exporters of manufactured products of sufficient size to cause some discomfiture in world markets. By 1976, 27 percent of developing country exports consisted of manufactured goods, and their share in world exports of manufactures had risen to 10 percent.

While 10 percent is still small, three features of the growth in manufactured exports caused attention. First, the rate of growth of manufactured exports from developing countries was extremely rapid, and the 10 percent share was simply a reflection of the fact that it had started from a very small base; continuation of that rate of growth would imply a rapidly increasing share of world markets in the not-to-distant future. Second, most of the rapid growth of manufactured exports was accounted for by a small number of developing countries. Third, the countries which accounted for most of the growth in manufactured exports also experienced very high rates of economic growth of their entire national economies. There was, therefore, a reasonable prospect both that this small group of countries would continue to increase its share in world markets and that other developing countries might adopt policies similar to those of the successful exporters, further accelerating the thrust of the developing countries into developed country markets.

The prominence of the relatively small group of developing-country exporters of manufactured goods led to the coining of a term—newly industrializing countries, or NIC's—to refer to them collectively. There is no precise agreement as to the exact list of NIC's, although all would agree that Brazil, Hong Kong, South Korea, Singapore and Taiwan are NIC's. Others are included when focus is upon developing countries' shares of world markets of manufactures.

[1] These figures, and the numbers in the next paragraphs, are taken from International Bank for Reconstruction and Development, World Development Report, 1979, August 1979, various tables.

The purpose of this paper is to examine the experience of the successful NICs, with three questions in mind. A first question is factual—what their export performance was, how their domestic economies have performed, and so on. The second question is more analytical—what are the reasons for NIC success, both in increasing their export markets and in achieving high sustained rates of economic growth. The third question probes the implications for U.S. economic policy. That in itself has two parts. On one hand, there is the issue of how likely it is that other developing countries can follow in NIC footsteps in penetrating developed country markets for manufacturers, and the implications of future penetration by existing and future NIC's into those markets. On the other hand, there are also implications for American policy with respect both to assisting the development of developing countries and to international trade.

The following three sections of this paper address the three questions in turn. Because focus is upon the success stories, most of the paper is concerned with the narrowly defined NIC's—the five countries cited above. In Section I, however, the performance of those NIC's, contrasted with other countries sometimes included in the category, is indicated and placed in perspective.

I. The Emergence of High-Growth NIC's

Who are the NIC's?

As already mentioned, there is no single list of NIC's. Some include those developing countries whose manufactured exports are a significant percentage of world markets in one or more manufactures. Others include those countries whose share has grown markedly over the past fifteen years. While there is obviously an overlap between the countries which have large shares and the countries with rapid rates of growth, it is far from complete.

Table 1 gives the geographic distribution of world exports of manufactures for 1963, 1973, and 1976. It indicates the share of world exports of manufactures for each of nine developing countries sometimes classified as NIC's. As can be seen, there are countries such as India, which had a relatively high share of manufactured exports in the

TABLE 1.—GEOGRAPHIC DISTRIBUTION OF WORLD EXPORTS OF MANUFACTURES

	In percent of world trade			In billions		
	1963	1973	1976	1963	1973	1076
Developed countries	80.49	82.25	82.76	$52.80	$233.26	$383.10
Argentina	.01	.21	.17	.01	.60	.79
Brazil	.05	.35	.41	.03	.99	1.90
Hong Kong	.76	1.05	1.15	.50	2.98	5.32
India	.85	.45	.49	.56	1.28	2.27
Korea	.05	.78	1.20	.03	2.21	5.56
Mexico	.17	.64	.51	.11	1.82	2.36
Singapore	.38	.46	.52	.25	1.30	2.41
Taiwan	.16	1.04	1.23	.11	2.95	5.69
Yugoslavia	.40	.55	.60	.26	1.56	2.78
Other developing countries	1.84	1.68	1.06	1.21	4.76	4.91
Total developing countries	5.29	8.63	8.67	3.47	24.47	40.13
Centrally planned economies	13.35	10.00	9.65	8.76	28.36	44.67
Total	100.00	100.00	100.00	65.60	283.60	462.90

Source: OECD, "The Impact of the Newly Industrializing Countries on Production and Trade in Manufactures," Paris, 1979, p. 19.

1960's, but whose share has fallen in the 1970's. Contrast the Indian performance with that of Singapore, whose share of manufactured exports in 1976 was only slightly larger than that of India, but whose share has increased rapidly since the early 1960's.

There is obviously considerable scope for defining which countries are, and which countries are not, NIC's. Since focus in this essay is on success stories, where market share have increased rapidly and domestic economic growth has been rapid, a relatively narrow criterion will be used: NIC's are considered to be those countries whose shares of world markets of manufactures were in excess of 0.4 percent in 1976, and whose shares had grown continuously and more than doubled over the period since 1963. That eliminates Argentina (share of less than 0.4 and declining after 1973), India (declining share), and Yugoslavia (insufficiently rapid growth of share). Singapore, according to Table 1, should be eliminated, but here high share in 1963 reflects spurious political factors and is thus included. Finally, Mexico's large share and rapid growth is largely a function of special factors, including offshore assembly provisions in the American tariff code; the Mexican experience is very different from that of other NICs, especially in light of Mexico's discovery of oil in the late 1970's. For that reason, it is not covered here. That leaves the five on which attention focuses in this paper: Brazil, Hong Kong, Korea, Singapore, and Taiwan. As can be seen from Table 1, those five increased their share of world exports of manufactures from 1.40 percent in 1963 to 4.51 percent in 1976. This represented a growth rate of manufactured exports (valued in current prices) of about 25 percent annually, compared with a rate for the world as a whole of about 16 percent.

Several characteristics of NIC performance are evident from Table 1. First and foremost, developing countries as a whole have increased their share of manufactured exports from 5.29 percent in 1963 to 8.67 in 1976. Secondly, most of the increased NIC share was at the expense of the centrally planned economies, whose share of world trade in manufactures actually fell over the period under review, while the OECD share marginally increased. Finally, the increased share in manufactured exports from developing countries, so widely discussed, has been confined to a very narrow range of countries, the NIC's. It is not a broadly based, widely diffused increase of manufactured exports, but rather a pronounced shift in the capability of a few developing countries to produce manufactured goods and compete in international markets.

Characteristics of NIC's as a Group

There are a number of obvious differences among the NIC's. Brazil is a large country, both in area and in population (115 million) with a fairly abundant and diversified endowment of natural resources (except oil). Singapore and Hong Kong are city states, with small populations of 2.3 and 4.8 million respectively. They differ significantly in that Hong Kong has been subject to large and fairly steady flows of migrants from China. Taiwan is much larger, with 16 million population, and is fairly well endowed with land, if not mineral resources. Korea, with a population of about 38 million, has more than twice the population of Taiwan, with a very high density of population and a very poor resource base.

The countries started their rapid growth era in very different circumstances. Brazil, Korea, and Taiwan had all experienced earlier periods of high inflation rates, multiple exchange rates, stringent import controls and slow growth. In the Brazilian case, the slow-growth phase from the late 1950's to about 1967 had followed an earlier rapid expansion in the late 1940's and early 1950's whereas Korea was recovering from Japanese colonial rule, partition of the country, and the Korean war, and experienced only moderate growth in the late 1950's prior to her shift. Taiwan, of course, underwent the dislocation of the inflow of migrants from the mainland after the Second World War, and then a fairly chaotic period during which inflation was rampant, exchange controls were stringent, and growth was slow. Hong Kong, as already mentioned, has been the continuous recipient of migrants from the mainland. Singapore, by contrast, did not become independent as a separate nation until 1965, when that country split with Malaysia.

Despite all these inherent basic differences, the experiences of the NICs, both in developing their export markets and in the growth of their domestic economies, are remarkably similar. Table 2 gives some salient data on their economic structure and growth.

The first row gives 1978 per capita income for each of the countries. All are classified by the World Bank as "middle-income" countries, as they have per capita incomes well below the industrialized countries (whose average was $8,070 in 1978), but well above the "low-income countries" (whose average was about $200 in 1978). Singapore and Hong Kong are the richest, reflecting in part their lack of a rural sector: if urban income levels were contrasted, the differences would be far smaller. Korea's per capita income is the lowest of the group, although Brazilian, Korean, and Taiwanese per capita income levels were within a range of several hundred dollars in the late 1970's.

TABLE 2.—SALIENT CHARACTERISTICS OF NIC'S STRUCTURE AND GROWTH

	Brazil	Hong Kong	Korea	Singapore	Taiwan
1. Per capita income, 1978 dollars	1,570	3,040	1,160	3,290	1,400
2. Average annual growth rates, percent:					
(a) Per capita real GDP, 1960–78	4.9	6.5	6.9	7.4	6.6
(b) Real GDP:					
(i) 1960–70	5.3	10.0	8.5	8.8	9.2
(ii) 1970–78	9.2	8.2	9.7	8.5	8.0
(c) Real manufacturing output:					
(i) 1960–70	(1)	(1)	17.2	13.0	17.3
(ii) 1970–78	9.5	5.6	18.3	9.2	13.2
(d) Exports:					
(i) 1960–70	5.0	12.7	35.2	4.2	23.7
(ii) 1970–78	6.0	4.8	28.8	9.8	9.3
(e) Imports:					
(i) 1960–70	4.9	9.2	20.1	5.9	17.9
(ii) 1970–78	6.6	3.2	13.5	8.1	9.1
3. Structure of trade:					
(a) Percentage manufactured exports:					
(i) 1960	3	80	14	26	(1)
(ii) 1977	26	96	85	44	49
(b) Exports of goods and services as a percent of GNP:					
(i) 1960	5	79	3	163	11
(ii) 1977	7	98	34	164	59

[1] Not available.

Source: IBRD, "World Development Report, 1980," various tables.

The next series of figures give estimates of growth rates. As can be seen, per capita real incomes rose very rapidly in all the NICs over the entire 1960–1978 period. Only Brazil experienced per capita income growth of less than 6 percent annually, and that is because the period covers both her low-growth years (1960–67) and the rapid growth years after 1968. That contrasts with an average growth rate of per capita income for all developing countries (including the NIC's and the oil exporters) of 3.0 percent over the same period. Thus the NIC's stand out as being countries with very high rates of growth of GNP, whether evaluated by standards of developing or of developed countries.

Rows 2.b.i and 2.b.ii give rates of growth of real GNP for the 1960–1970 decade and for 1970–1978. The abrupt increase in Brazil's rate of economic growth is only partially visible in these figures as there was rapid growth during the last three years of the 1960's. The other NIC's maintained excellent growth performance in the 1970's, despite the fact that all of them are oil importers and were confronted with the oil shock of 1973–1974. Rows 2.c.i and 2.c.ii give rates of growth of manufacturing output. As can be seen, in all cases except Hong Kong, the rate of growth of the manufacturing sector exceeded the growth rate of total GNP, reflecting the growing importance of the manufacturing sector in the economies of the other four countries.

The rates of growth of exports, given in rows 2.d.i and 2.d.ii, are not strictly comparable with rates of growth of manufacturing output, because manufactured exports in the NIC's generally grew much faster than total exports. Comparison of rates of growth of exports with rates of growth of real GDP indicates that exports were increasing, as a share of GNP, in all countries, as can be verified by examination of rows 3.b.i and 3.b.ii. Imports grew much in line with exports in most of the NIC's. Korea started the 1960's with a large excess of imports over exports, financed largely by foreign aid. As aid was phased out and diminished in importance during the 1960s, exports had to grow more rapidly than imports in order to maintain a balanced payments position.

Finally, rows 3a give the percentage of exports that consisted of manufactured goods in the various NIC's. As can be seen, that percentage has risen sharply in all cases.[2] The very high shares for Hong Kong and Korea reflect the fact that both countries have a strong comparative disadvantage in natural resources. For Singapore, the failure of the share of manufactures to be higher is the result of her large reexports of petroleum products and the fact that some Indonesian exports are recorded in the Singaporean trade statistics. For Brazil, the fact that the share of manufactured exports remains so low reflects in part the comparatively good natural resource endowment, which makes coffee, cocoa, soybeans, and some mineral products natural exports, and in part that the country is still far from fully industrialized with a sizable fraction of her population still in the rural sector.

These, then, are the salient features of the NIC's remarkable performance. In all cases growth was extremely rapid, and was accompanied by a marked increase in each country's participation in international trade and by rapid industrialization.

[2] Comparable data are not available for Taiwan for 1960. However, the share of manufactures in exports rose in that country, too.

This is not to imply that agriculture was neglected. On the contrary, as will be seen in Section II, growth of the rural sector contributed importantly to overall performance in all but the city-states.

II. Reasons for the Success of the NIC's

There is not unanimous agreement on the precise formula for the success of the NIC's, although there is a general consensus as to some of the ingredients that were clearly necessary. Moreover, there were some unique aspects to each NIC's success, as particular elements originating out of the country's situation and history played a role in the economic transformation.

This section contains, therefore, a brief examination of the policies adopted in each country, and the factors that proximately surrounded success. Thereafter, attention turns to the generalizations that can be drawn from these cases, and the likelihood that other countries can follow in the path of the successful NIC's.

Individual Countries

Brazil

By the mid-1960's, it was evident to all observers that the rapid rate of growth Brazil had achieved in the early 1950's had ground to a halt. Per capital incomes had hardly risen in the preceding half decade, export earnings had not reattained their 1953 level, and, by 1963, the annual inflation rate was in excess of 80 percent.

For the next three years, until 1967, the government followed "orthodox" policies, attempting to control the rate of growth of the money supply and generally deflating the economy. There were also important monetary reforms, which in effect indexed many transactions, including interest on loans. Accompanying these measures, the cruzeiro was devalued fairly sharply; there was some increase in export earnings, but it was not impressive, especially against the background of earlier stagnation. Overall, the interim period was characterized by some slowdown in the rate of inflation, and a recession in domestic markets. The government alternated somewhat between periods of monetary stringency, aimed at controlling the rate of inflation, and periods of macroeconomic stimulus, aimed at reducing the severity of the resulting recession.

In late 1967 and early 1968, there was a second, significant, policy shift. The government simultaneously announced a new exchange rate policy and altered the incentives for exporting. Whereas earlier the cruzeiro had been devalued infrequently by sizable amounts, it was announced that henceforth there would be small, frequent devaluations so that the purchasing power parity of the cruzeiro would be maintained vis-a-vis Brazil's foreign trading partners.[3] This gave domestic producers assurance that domestic inflation would not make export contracts unprofitable.

Concurrently, a series of "export incentives" was announced which in effect greatly increased the profitability of selling abroad. It has been estimated that these incentives, which took the form of tax rebates, exemption from income and profits taxes in accordance with ex-

[3] The rate of inflation had fallen significantly from its 1961–63 heights, but nonetheless continued in the range of 16–23 percent over the 1968–1973 period.

port performance, and so on, made it profitable to export at approximately two-thirds the price received in the domestic market.[4] This enhanced profitability of exporting served largely to offset the export disincentives that were inherent in the Brazilian import substitution regime.

The export response was surprising to all observers. Export earnings, predominantly from natural-resource-based activities prior to the reforms, had been $1.9 billion in 1968. They rose sharply thereafter, reaching $6.2 billion in 1973. As already mentioned, much of the growth was in manufactured exports, but important new agricultural commodities also emerged as significant export items.

Brazil's export boom was broadly based over a wide range of engineering and mechanical goods, which require some labor skills and some capital: in 1970, 21 percent of exports were metallurgical products; machinery and electrical equipment each constituted 5 percent of exports; chemicals were 12 percent, and transport equipment 9 percent of all exports. Although processed foods and textiles were among the products exported, Brazil's export boom was not based on the industries usually associated with a high labor intensity, but rather on the "middle-range" industries.

Accompanying the rapid increase in exports, the rate of growth of real output, which had scarcely exceeded the rate of growth of population in the early 1960's, was more than 10 percent annually over the 1968–1973 period. For an economy the size of Brazil, such a rate of increase over even half a decade was remarkable, and implied a rate of growth of income per capita of about 7 percent annually. As can be seen from Table 2, this rate was almost sustained over the 1970–1978 period, although there is considerable evidence that performance in 1979 and 1980 will have been far less satisfactory.

Although there are a number of observers who are critical of various aspects of Brazil's growth,[5] there is no question but that the switch toward an export-oriented policy was a significant, if not the key, factor in Brazil's altered economic structure and prospects. That in turn required not only a realistic exchange rate policy, but incentives to export as an offset for the protection accorded to producers for the home market *and* reasonable assurance that these policies would be continued over a period of time. While the slowdown in the rate of inflation undoubtedly facilitated the transition to a more export-oriented industrialization and trade policy, it was not the crucial ingredient. The monetary reforms (including indexation) were probably a factor of some significance, and it is doubtful whether the response to the export incentives could have been as great as it was in the absence of those reforms. Nonetheless, the primary route through

[4] José Carvalho and Cláudio Haddad, "Foreign Trade Strategies and Employment in Brazil," in Anne O. Krueger, Hal B. Larry, Terry D. Monson, and Narongchai Akrasanee, eds., "Trade and Employment in Developing Countries, 1: Individual Studies," University of Chicago Press, 1981.

[5] In particular, there is a controversy over what has happened to the Brazilian income distribution, and the real wages accruing to various groups in the population, during the period of rapid growth. World Bank estimates indicate that the real income of the bottom 40 percent of the population grew at an average annual rate of about 5 percent over 1960–70, whereas real GNP grew at an average rate of 6 percent. See Hollis Chenery, Montek S. Ahluwalia, et al., "Redistribution with Growth," p. 14, Oxford Press for the World Bank, 1974. See also G. S. Fields, "Who Benefits from Economic Development:–A Reexamination of Brazilian Growth in the 1960s," American Economic Review, September 1977 and the comments in the American Economic Review, March 1980; and A. Fishlow, "Brazilian Size Distribution of Income," American Economic Review Proceedings, May 1972.

which rapid growth occurred was through the reorientation of trade strategy. In this regard, it should be noted that trade was, and remains, a relatively small fraction of the Brazilian economic activity. Given the size and diversity of the Brazilian economy, this is not surprising. What may be surprising is that the expansion of exports, which, while sizable, was not all that great relative to GNP, could generate such a large change in the rate of growth of GNP.

Hong Kong and Singapore

As Tables 1 and 2 showed, both Hong Kong and Singapore have grown rapidly, and an export-orientation has been a key ingredient of that growth. Singapore has welcomed foreign capital, and much of Singapore's industrial development has been in relatively capital-intensive industries (such as petroleum refining) financed with private foreign investment. Indeed, Singapore has confronted a relatively tight labor supply, and has permitted some immigration of workers from South and Southeast Asia to supplement her domestic labor force. By the early 1970's, the Singaporean government was discouraging expansion of labor-intensive industries. In contrast, Hong Kong's relatively abundant labor supply from mainland China has led to much greater reliance on labor-intensive industries in her development process and private foreign capital has played a much smaller role. This has happened, not through any conscious government policy (as in the case of Singapore), but rather through the workings of the market. Hong Kong has been aptly characterized as "the world's last bastion of nineteenth-century free-trading laissez-faire," [6] although land used in both Hong Kong and Singapore is carefully regulated by the government, and infrastructure investments have been important in permitting rapid growth.

In both cases, as is necessary for an export orientation, there have been few quantitative restrictions on international transactions, and the currency has generally been readily convertible. Both Hong Kong and Singapore have developed their financial markets and played a role as an Asian center for "Eurodollar" transactions. From the beginning of their export-oriented efforts, both have relied almost exclusively on a realistic exchange rate, and a lack of protection to imports, to encourage exports. They did not have a high wall of tariff protection to offset, and thus did not have to dismantle the complex machinery of an earlier, protective, exchange control regime.

Korea [7]

Despite the enormous differences between Brazil and Korea, the sequence of events which led to the period of phenomenal growth was remarkably similar. As of the late 1950's, Korea had a highly overvalued exchange rate, rapid inflation (at rates in excess of 100 percent during the Korean War and of about 25 percent annually in the mid-1950's). Growth was only moderate despite the large opportunities for rapid recovery after the Korean War and a sizable volume

[6] Tzong-Biau Lin and Yin-Ping Ho, "Export-Oriented Growth and Industrial Diversification in Hong Kong," paper presented at Eleventh Pacific Trade and Development Conference, Korea Development Institute, September 1980. See also Alvin Rabushka, "Hong Kong: A Study in Economic Freedom," University of Chicago Press, 1979.

[7] For additional information on Korea, see Charles R. Frank, Jr., Kwang Suk Kim, and Larry E. Westphal: "Foreign Trade Regimes and Economic Development: South Korea," Columbia University Press, 1975; Anne O. Krueger, "The Developmental Role of the Foreign Sector and Aid," Harvard University Press, 1979 and Kwang Suk Kim and Michael Roemer, "Growth and Structural Transformation," Harvard University Press, 1979.

of American aid, which exceeded 10 percent of Korean GNP for several years in the mid-1950's. The balance-of-payments position was extremely difficult, as exports were less than one-fifth of imports, and foreign aid financed the import bill.

Aid inflows peaked in 1957, and it became obvious to all that Korean economic prospects were dim indeed if a means of increasing export earnings was not found. It is noteworthy that, at that time, 88 percent of Korean exports were raw materials.

In 1960, the exchange rate was significantly devalued. In addition, some exports exporters were given credit at low interest rates, exemption from import duties on raw materials and capital goods, tax reductions, and export bonuses. Thereafter, export incentives were increased whenever exports began lagging, or when Korean inflation outstripped that in the rest of the world. As in Brazil, these incentives served largely to offset the protection domestic producers had received in the home market over time. The exchange rate increased in importance, while other incentives diminished or were phased out.

From a very small base, Korean exports began expanding rapidly, from 3 percent of GNP in 1960–1962 to 28 percent of GNP in 1973–1975, for an average annual rate of growth of over 40 percent. Given the low initial real wage in Korea, it is hardly surprising that the initial export bundle was highly labor intensive: textiles, clothing, footwear, wigs, and plywood (with imported logs from Indonesia) were among the export industries that boomed in the early and mid-1960's. By the late 1960's, the Korean labor force had acquired greater skill, and a high rate of capital formation meant that there was more available capital per worker. Electronics began emerging as another export industry, and, in the early 1970's, some components of machinery and transport equipment entered the export list.[8] There was thus in the 1970's some tendency to shift toward slightly less labor intensive activities, as Korea's labor force was fully utilized and the real wage was rising.[9]

By 1966, it became clear that the Korean economy's growth potential was greater than could be sustained if only domestic savings were employed to finance new investment. Consequently, the Korean government decided to attract foreign capital. It began borrowing from abroad, and also permitting private foreign investments. Thus, while aid was diminishing sharply, and finally ceased, foreign lending increased in importance, financing about two-fifths of gross investment in the late 1960's and over a third in the early 1970's.[10] Until the 1970's, equity investment was relatively small.

Foreign borrowing could not have been undertaken on the scale that it in fact was had it not been for the rapid rate of increase in export earnings. Export growth made Korea creditworthy, thus enabling ready access to the private international capital market.

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[8] Some have questioned the extent to which Korea's successful export drive was made possible by her "special relationship" with Japan and/or with the United States. Inspection of the evidence does not suggest that either was of prime importance: Japan's share of Korean exports fell during the growth period of the 1960s, and there is no evidence that Korean exports received treatment different from that which exports from other countries might have received. See Frank, Kim, and Westphal, pp. 81 ff.

[9] In the middle 1970's, the government began a push toward the development of highly capital intensive industries. These large-scale investments have not, to date, proven economic, and appear to have led to some structural difficulties within the Korean economy. A resolution to these problems is not yet in sight.

[10] See Charles R. Frank, Jr., Kwang Suk Kim and Larry E. Westphal, "Foreign Trade Regimes and Economic Development: South Korea." Columbia University Press for the National Bureau of Economic Research, 1975, pp. 106 ff.

Korean imports rose rapidly along with her exports. Although, as seen in Table 2, the rate of growth of imports did not match that of exports,[11] the increase in absolute terms was nonetheless spectacular: Korean imports rose from $344 million in 1960 to $1,982 million in 1970 and $14,972 million in 1979. Thus, Korean growth was not simply an export-based boom: the economy underwent a structural transformation as all segments of economic activity were opened up to the international economy.

In that connection, the Korean government had a significant role. On one hand, infrastructure investments of all kinds—electricity, transport facilities including roads, railroads and ports, and communications—had to expand in step with production and exports. The government played a major role in estimating the feasible rate of growth of industrial production, and then generating the infrastructural capacity to insure that capacity could be utilized. On the other hand, the government also served as an indicator, for the private sector, of approximately what rate of expansion could be expected. While it did not to any significant degree intervene with quantitative or other direct controls, incentives were altered in ways designed to assure that the socially desired objectives were met.[12]

Like Brazil, the Korean authorities followed an exchange-rate policy that resulted in maintaining purchasing power parity for the won at a realistic level in the late 1960's. During some periods, this was accomplished by an announced "sliding peg" policy of small, frequent, exchange rate adjustments. During other periods, export incentives were altered to keep the real proceeds to exporters from a dollar of exports fairly constant. In practice, this happened because the government reacted quickly to restore incentives whenever export performance started lagging. By the early 1970's, however, Korea was well established in world markets and there was some scope for real appreciation of the won.

Several other aspects of the Korean experience deserve note. As in the Brazilian case, there were significant monetary reforms (in 1964–1965) which significantly increased the real cost of borrowing. Although the effectiveness of the interest rate reforms was largely reversed with the more rapid inflation that occurred after the oil price increase of 1973, they nonetheless reduced the degree to which capital and credit markets in Korea were distorted and permitted a smoother flow of resources into profitable (generally exporting) activities than would otherwise have been possible. Unlike the Brazilian case, Korean growth appears to have been accompanied by a fairly even income distribution, which (at least until the late 1970's) appears to have become no worse, and perhaps even became more equal, during the rapid growth period.[13]

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[11] This was because some export earnings went to reducing the proportionate size of the trade balance deficit and to offset the declining volume of aid.

[12] Incentive polices have even carried over into family planning, and the crude birth rate per thousand fell sharply, from 41 to 21 per thousand over the period 1960 to 1978. The rate of population growth thus fell from 2.8 to 1.3 percent over that interval.

[13] There is some evidence that the real wage declined during the first several years of the export drive, although it rose rapidly thereafter. Whether this decline resulted in an improvement or a worsening of the terms of trade is difficult to say: employment in industry rose extremely rapidly, so that low-income persons from rural areas experienced an improvement in their lot at the same time as persons already in the industrial labor force were, at least temporarily, worse off. After 1966, the real wage began increasing rapidly, and the economy was generally at full employment.

Finally, the agricultural sector has not been neglected during the rapid shift toward an industrial base. Indeed, agricultural output grew at an average annual rate of 4.5 percent during the decade of the 1960's, and at a rate of 4.0 percent from 1970 to 1978. This increase took place despite a fairly rapid outmigration from the rural areas, as manufacturing employment expanded at an average annual rate of 10.9 percent.

Taiwan

There are some strong similarities between Taiwan and Korea. Both experienced dislocation, Taiwan because most of her population were refugees from the mainland, and Korea because of partition and the Korean War. Both were major recipients of American foreign aid during the early 1950's, and were subject to rapid inflation, multiple exchange rates, and severe balance-of-payments difficulties. Taiwan, like Korea and Brazil, had a period of import substitution in the early 1950's. The major difference is that Taiwan had a relatively abundant endowment of arable land, so that her resource base was considerably better than Korea's.

In the late 1950's, the government introduced a series of reforms, including a significant devaluation of the currency, unification of the multiple exchange rate system, and removal of many quantitative restrictions upon imports. This was followed by the development of an export boom and a sharp increase in the rate of economic growth. Exports, which constituted 12.2 percent of national income in 1958 (with imports equaling 20 percent of national income and foreign aid covering much of the difference) rose to 19.6 percent of national income by 1965. By 1969, exports were almost equal to imports, as rapid growth of exports continued. During the decade of the 1960's, export volume rose fivefold, while imports rose fourfold: exports grew enough to substitute for foreign aid and to permit large increases of imports. The latter was of course necessary if the economy was to open up significantly.

Taiwan's initial rapidly-growing exports included a number of processed foodstuffs, including canned pineapples, canned mushrooms, and similar products. Very quickly however, the export list expanded to include textiles, clothing, electrical machinery, and other manufactures. As in Korea, the boom in exports and real income was accompanied by rapidly rising employment and real wages. Most observers credit Taiwan, also like Korea, with a fairly even income distribution, which remained substantially unaltered during the growth process.[14]

Generalizations

Importance of exports

What seems clear, both from an analysis of the experience of the NIC's, and from comparison with those of countries continuing to adhere to more restrictive, import substitution, trade and industrialization strategies, is that export growth has played a key role in their excellent performance. In part, the rapid growth of exports itself contributed but, in addition, the policies that had to be implemented in order to mount an export-oriented industrialization strategy also helped.

[14] See John Fei, Gustav Ranis, and Shirley Kuo, "Growth With Equity: the Taiwan Case," Oxford University Press, 1979.

There is, by now, fairly general agreement as to the fact that the export-oriented strategy and export growth were integrally associated with the achievement of high overall rates of growth. And, the reasons why these differences have arisen have, in large part, been identified. What is not agreed-upon is the relative importance of each factor, which may have differed from country to country as well as at different times within the same country. In this section, the various reasons why an export-oriented strategy seems to have been so vastly superior to the alternatives are sketched, but no effort is made to assess the relative importance of each factor.[15]

A successful export-oriented development strategy does three things. First, it permits countries to take better advantage of the technological opportunities available to them. Second, it prevents them from making some of the costly mistakes often associated with inner-oriented, restrictive, trade and development industrialization strategies. Third, it forces policies upon government which generally lead to better economic performance of the private sector.

Turning to technology, there are several important reasons why an export-oriented strategy has generated such vastly superior performance. Poor countries, even those such as Brazil with realtively large populations, generally have relatively small domestic markets for most manufactured goods. When protection makes profitability depend on selling in the domestic market, production runs and capacity are often of sufficiently small size so as to be uneconomic. By orienting production toward exports, developing countries' producers are enabled to construct their manufacturing facilities at an efficient size and to produce in economic-size batches, thereby taking advantage of economies of scale in the production process.

In addition to the minimum-efficient-size considerations, there is a second technological factor that permits better growth performance under exporting. That is, poor developing countries have, by definition, abundant supplies of relatively unskilled labor and are relatively capital (and skill) scarce. An export-oriented strategy permits those countries to use the international market to exchange their own, relatively labor-intensive commodities, for capital-intensive goods. They are thus enabled to take advantage of the division of labor and of specialization, which are important advantages of international trade. This contrasts sharply with imports substitution policies under which labor-abundant developing countries develop the entire spectrum of manufacturing industries and experience high and rising capital-labor ratios. Given their small stock of capital, it proves to be impossible to productively employ the labor force, and the growth rate slackens.

The second apparent reason for the success of export-oriented strategies lies in the necessity for them to rely on incentives to guide economic activity and to avoid direct controls. Under import substitution, there appears to be an almost irresistable pressure upon policy-makers to regulate in domestic markets, using price controls, physical allocations, investment licensing and other interventions in all aspects of economic life. These interventions often "fight the market" in that policy-makers are attempting to induce individuals to undertake unprofitable actions or to refrain from taking profitable ones. Regula-

[15] This section draws on my paper, "Trade as an Input to Development," American Economic Review Proceedings, May 1979.

tions and controls become increasingly detailed and complex over time. Usually, it becomes impossible to ascertain the degree to which relative prices and costs are distorted. Consequently, import substitution regimes often end up with a highly variable, erratic, and complex incentive structure with a mix of quantitative controls and pricing incentives. The fact that there are large differences in the degree of protection accorded to different industries (and firms), that many controls entail dead-weight losses in resource allocation, and that the system becomes increasingly cumbersome over time all combine to reduce the rate of growth of output and productivity.

By contrast, export-oriented policy-makers cannot intervene quantitatively to the same degree. Incentives, whether they are embodied in a realistic exchange rate or in favorable treatment to exporters, generally are relatively uniform among exporting firms, as the measure of success is export earnings rather than physical units of individual export commodities. Both because the exchange rate generally must be kept fairly realistic, and because detailed quantitative interventions are not feasible in the export market, the wide variation in incentives often encountered in import substitution regime is generally absent in export-oriented regimes.[16]

In addition to these features of policy, there is another factor that seems to contribute to better growth performance under an export promotion strategy. That is, the stop-go aspects of macroeconomic policy associated with periodic "foreign exchange crises" under import substitution are avoided. In almost all developing countries with import-substitution policies, there has been a chronic tendency for the rate of growth of demand for foreign exchange to exceed the rate of increase in foreign exchange availability. Policy makers have periodically had to adopt restrictive monetary and fiscal policies as mounting levels of foreign indebtedness have led to debt rescheduling and "stabilization policies." These stop-go cycles are largely avoided under export-promotion, as export earnings grow rapidly enough to finance the increased demand for imports.

The third factor, economic behavior, is closely related to the second. Under an export-oriented trade and industrialization strategy, individual enterprises are confronted with competition in the international marketplace. Competition itself tends to make firms more efficient. In addition, at any given time some firms are more efficient than others. Under a competitive system, those firms are more profitable and expand relatively rapidly, while the least efficient firms are subject to the opposite pressures. Growth takes place not only through across-the-board expansion in output and cost reductions, but also through shifting resources toward the more efficient producers. Under import substitution, there generally exists an industrial structure in which there are few firms producing a particular item. This is in large part because of the small size of the domestic market, referred to earlier, but also because mechanisms for allocating scarce foreign exchange tend to guarantee market shares and reduce whatever competitive forces there may be in the system. The absence of competition, and the

[16] There also seems to be a quicker feedback from policy mistakes under an export-oriented strategy. If the exchange rate starts becoming overvalued, for example, flagging exports quickly bring the situation to policymakers' attention. If export subsidies are used to compensate, the cost of these subsidies puts pressure to alter the exchange rate. If policymakers do decide to encourage exports from the "wrong" industry, the cost of that decision is reflected in one way or another to them.

fixity of market shares under import substitution, are undoubtedly an important factor in explaining the much slower growth of factor productivity and higher capital-output ratios in Korea and Brazil in their earlier import-substitution years and in India, Turkey, and other import-substitution countries at the present time.

Other factors

As the above discussion implies, an export-oriented strategy is not simply a governmental decree that exports are desirable: all countries have that. Rather, it is an entire set of policies that are oriented toward encouraging production of goods and services efficiently.[17]

For that reason, there is a significant question as to the extent to which it is the fact of exporting itself, or the other policies that have accompanied export efforts, which have led to the superior growth performance experienced by the NIC's. While there is no definitive answer to this question, it seems evident that some accompanying policies—improvement of the functioning of credit markets, financial reforms, and rationalization of incentives—enhanced the benefits that accrued from export-oriented strategies, while others, such as liberalization of the import regime, and adoption of a realistic exchange rate, were necessary for the success of the export-promotion strategy. Likewise, some of the growth-enhancing features of an export orientation mentioned above originate in the utilization of the international marketplace, while others are by-products of more rational economic policies.

What does seem clear is that all the successful NIC's have had governments which were committed to economic growth, and to growth through exporting. In all cases, not only were domestic producers confronted with adequate incentives for exporting, but they could be reasonably confident that incentives would continue to be adequate. This relatively-assured stability of policy has undoubtedly been a factor of some significance in fostering economic growth, and it is doubtful whether, in the presence of a shaky government, the same incentives would have called forth the same response.

Likewise, the fact that the governments were committed to economic growth led them to evaluate policy alternatives largely on the basis of their presumed impact on economic growth. This growth orientation in itself may be a central distinguishing feature of the NIC's, although there have been a number of countries adopting restrictive trade regimes where all political rhetoric has indicated that growth was a primary objective.

Finally, there is the consideration that success breeds success. The NIC's, were, in hindsight, successful. As their governments embarked upon the export promotion and related policies, it was by no means so clear in prospect that high growth would be achieved. Indeed, in many other countries (including Brazil in 1957, ten years before the successful effort), efforts to alter the trade and payments regime and related policies have been undertaken, only to meet with political opposition when they were not initially overwhelmingly successful. Once the NIC's met with initial successes, the desirability of the export-oriented

[17] Many import-substitution countries, notably India and Turkey, have special policies to promote exports, and provide export subsidies to individual manufacturing commodities if they are exported. Those policies really serve only to offset the very strong incentives to produce for the domestic market, and they can lead to the same chaotic set of high rates of implicit subsidy and protection for the exporters as there is for import substitution firms. Careful analysis of those trade regimes suggests that the export incentives which do exist are really for import-substitution industries to export some part of their output.

policies was evident to large segments of their societies, and support for continuation of the effort arose out of success. In other countries, initial efforts have not been so successful and consequently, opposition to continuing them has mounted. It is at least arguable that those countries, too, might be NIC's if their policies had initially met with greater success. One of the major lessons of the experience of the developing countries over the past two decades is that, once in a highly restrictive, inner-oriented trade regime, it is extremely difficult to undertake a major liberalization effort.[18] Each of the NIC's did so, and there was a factor of luck involved. Additionally, however, all NIC's embarked upon their export effort against the background of rapid expansion of international trade. Their success would have been less probable had the international economic environment been less favorable.

III. Policy Implications

What the NIC's Have Shown

Rapid growth is possible

The experience of the NIC's is reassuring in many ways, though not a cause for complacency. First and most important, the lesson of the NIC's is that it is possible for labor-abundant, resource-poor countries, as well as other low-income countries, to generate sustained rapid growth. Twenty years ago, there was little basis on which to believe that the gap between the rich nations and the poor could be narrowed, much less closed. The lesson of the NIC's is that the gap can at least be reduced considerably. Doubling or tripling per capita income within fifteen- and twenty-year periods makes a profound difference to the quality of life for a country's inhabitants; it has certainly transformed the societies of the NIC's.

Growth can be consistent with equity

The second lesson is that rapid growth can be consistent with goals of equity and improving the living standards of the poorest part of the income distribution.[19] In the late 1950's, the rural population of Korea was probably as poor as any rural population in the world outside of the South Asian countries; today, living standards are close to the highest among those in rural areas in developing countries.

NIC's are major markets for industrialized countries

Third, the rapid growth of the NIC's has created new, large markets, and expanded international trade for the developed countries as well as for the NIC's themselves.

Aid contributed to success

U.S., other bilateral, and multilateral aid institutions played an important role in laying the foundation for the rapid-growth spurt of the NIC's. While aid was being reduced in Korea, Taiwan and Brazil during their rapid growth periods, it had been an important element in their prior development. For Singapore and Hong Kong, the colonial relationship provided some of the same assistance.

[18] See my "Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences" for a fuller analysis of these issues.

[19] Indeed, rapid economic growth is the likeliest means of improving the lot of the poor. This calls into question some aspects of the basic human needs emphasis of American foreign assistance.

Continued access to markets is important

As a qualification to the above, it should be mentioned that future continued rapid growth of the NIC's is not automatically assured. Like other countries, they are having difficulty adjusting to the oil price increase and worldwide inflation. There is also a significant risk that restrictionist policies in developed countries may impede the further export growth of the NIC's, with adverse effects upon their future economic performance. Nonetheless, the NIC's are in a far better position to adjust to fluctuations in the international economy than are countries which have not experienced a similar spurt in growth over the past two decades; the developing countries least adversely affected by the oil price increase of 1973–1974 and the following worldwide recession were precisely the export-oriented developing countries.[20]

Implications for U.S. Policy

The implications for American international economic policy can be discussed under three major headings. First, there is the question of the role of aid in assisting economic development. Second, a range of issues in trade policy can be evaluated in light of experience with the NIC's. Finally, there are implications for U.S. economic growth and the interrelationship between domestic and trade policies.

Role of aid

As already mentioned, the three largest NIC's were all major recipients of foreign aid from the United States at an earlier stage of their development. The period as an aid recipient generally preceded the years of rapid growth, but aid was nonetheless of clear value, both in establishing a basis for making the transition to an export-oriented trade strategy and in providing technical and other assistance during the transition years.

1. Aid Financing of Capital Accumulation.—Aid-financed infrastructure in Brazil, Korea, and Taiwan was instrumental in permitting the economies of those countries to respond to the altered incentives associated with their export drives. It probably was important, too, in financing earlier investments that gave experience and training to businessmen and the labor force in the industrial sector, as well as in providing technical and other assistance to the rural sector which permitted sufficiently rapid growth of agricultural output and productivity to sustain the rapid growth of the industrial sector.[21]

2. Aid Assistance with Policy Formulation.—There was a second way in which aid was important in the major aid-receiving NIC's. That is, economists associated with the foreign assistance missions were influential in discussions with government officials that in turn were instrumental in bringing about the policy reforms. In the Korean case, for example, the entire stabilization program of 1957–1958 was carried out in conjunction with American economists at the aid mis-

[20] Political uncertainties are also a factor. As the lesson of Argentina aptly demonstrates, political problems can thwart economic development even among very wealthy countries.

[21] One of the phenomena which economists are least well able to quantify, given the existing state of knowledge, is the contribution of these phenomena to the development effort. It is therefore largely a matter of judgment to assess the importance of aid in laying the groundwork for the later export stage. In this writer's judgment, the ability of each economy to respond to the altered incentives was greatly enhanced by prior aid.

sion. Later, export incentives were introduced again after joint discussions. The aid mission hired several economists to work with the Koreans in formulation of their five year plans that underlay economic policy at that time. Finally, American monetary experts, financed by U.S. assistance, were instrumental in bringing about the monetary and fiscal reforms of 1964–1965.[22]

3. Crucial Role of Aid in Early Stages.—With hindsight, it appears that the timing of the phase-out of aid was probably appropriate. By the time aid began diminishing, the recipients had developed their own capacity for policy formulation and execution, and were well established in their export drive. That being the case, they could resort to the private international capital market for their additional financial needs, although technical assistance activities of various national and international foreign assistance agencies remained important.

It would thus appear that official development assistance has a vital role to play in countries at early stages of development, in providing both needed additional funding for imports and investment and also technical assistance of a wide variety of sorts, including economic policy-making as well as the more traditional areas.

In the early stage of development, countries cannot resort to the international capital market, and private foreign investment cannot substitute for the range of infrastructural and technical assistance program that can be effected through official development assistance. When countries reach the "middle-income" category, official development assistance is less important as a source of infrastructural investment, although the technical assistance component can still be of vital importance. In addition, foreign aid may be vital in providing the necessary margin with which to finance the transition to an export-oriented economy.

Trade policy

As the experience of the NIC's clearly demonstrates, there is a point beyond which aid cannot substitute for trade. At that stage, access to international markets for a country's exports is vital for the prospects for sustained rapid growth. With a successful export drive, international private capital markets can be tapped for any desired excess of the domestic investment rate over the rate of saving.

For American trade policy, the lessons are several. First, in the early stages of the export-drive phase, export subsidies and other policies on the part of the developing countries can be appropriate. Second, there is the difficult issue of "graduation" for IDC's, and a question as to what the criteria for it should be. Third, there is the importance of keeping American (and other OECD) markets open for LDC products, and growing at a satisfactory rate.

1. Export Subsidies.—Take first the issue of export subsidies and related measures adopted by developing countries. The experience of the NICs which used these measures is that they were important, early in the export drive, as offsets to the incentives for import substitution which had been inherent in the earlier trade regime. As the export drive was successful, the NIC's were able to substitute realistic exchange rate policy and other measures for the so-called export sub-

[22] See David Cole and Princeton Lyman, "Korean Development: The Interplay of Politics and Economics," Cambridge, Harvard University Press, 1971. The list of assistance with institutional development and technical matters is far from complete.

sidies. In principle, governments can either devalue their currencies or impose simultaneously import duties and export subsidies. Either set of policies has the same effects on resource allocation among tradable goods, although exchange-rate alteration is preferable because of its symmetric treatment of capital flows. In practice, a country embarking upon a switch in trade strategy away from import substitution already has in place a great many incentives for import substitution. It may prove politically more feasible to extend additional incentives to exports through the "subsidy" policy than it is to remove existing levels of tariff and other protection to imports. This certainly seems to have been the case with the NIC's.[23] As the export drive has succeeded, exchange, rate realignment has increasingly replaced elements of subsidy for exports.

Uniform, across-the-board, subsidies for exports, or even for most exports, are of course quite different from industry-specific incentives of a type that some countries have adopted. When countries are shifting from import-substitution to export strategies, it is politically easier to grant export subsidies than it is to remove tariffs and devalue. These subsidies really constitute a substitute to currency devaluation. Given the desirability of an export orientation for development and the infeasibility of such a path with specific and highly varying rates, it would appear that there is a strong case for U.S. policy which would accept fairly uniform export incentives, but would object to industry-specific export subsidies.

2. The Graduation Issue.—This, however, raises the second question: at what stage have NIC's proceeded far enough in their development that they should "graduate" and become subject to the same rules of international trade as present OECD members?[24] Graduation is desirable, not only because at some point NIC's are sufficiently developed so that export subsidies and related measures are no longer necessary or desirable, but also because NIC's themselves must assume responsibility for opening up their own markets to those of other developing countries as they attempt to develop their own export markets.

It seems evident that some criteria for "graduation" are necessary. The issue is a difficult one. Clearly, "graduation" from eligibility for GSP treatment might be subject to a different set of criteria than "graduation" from the need to use export subsidies. There is no single and self-evident criterion which would be optimal in all circumstances.

It probably would make sense to involve all developing countries in decisions as to what criteria should be, rather than to impose them unilaterally. Among the biggest gainers from graduation are likely to be other developing countries. Their inclusion in negotiations to develop satisfactory criteria could prove useful in removing the discussion from any appearance of confrontation between developed and developing countries.

To date, criteria have been developed only for GSP eligibility, and that has been based (in the U.S.) on export performance in individual commodity categories. For other trade practices (such as export sub-

[23] It is also possible that the psychological "signalling" effect of the export subsidy policy is greater.

[24] There is also a "graduation" issue in terms of tariff preferences for developing countries. See Isaiah Frank, "The 'Graduation' Issue for LDC's," in Journal of World Trade Law, July/August 1979.

sidies), overall export performance might prove a preferable criterion (assuming that export subsidies are fairly uniform across commodity groups). This could encourage countries, once their export orientation was well established, to switch from subsidies and tariffs to exchange rate realignment. Presumably a grace period, for gradual transition might be extended, once, say, a country had doubled its share of trade or achieved ten or more years of consecutive export growth at more than, say, twice the rate of growth of world trade.

3. Liberal Trade Policies in Developed Countries.—These considerations lead immediately to the third aspect of trade policy: the importance of maintaining access to developed-country markets for products from developing countries. It should be recalled that the NIC's have become increasingly important markets for exports from developed countries. Table 3 gives an indication of the extent to which they have expanded their imports. As can be seen, American exports to NIC's grew rapidly over the period of their rapid growth

Perhaps even more compelling, however, is the consideration that, at least beyond a certain stage, prospects for rapid growth of developing countries hinge crucially on their ability to develop exports of commodities that use their comparative advantage. If world markets are growing only sluggishly or are stagnant, the likelihood that developing countries' governments can successfully carry out export-oriented policies will be substantially diminished, and the prospects for other countries attaining the status of NIC's and for NICs' continuation of their growth performance, will be dim indeed.

TABLE 3.—NIC's AS A MARKET FOR DEVELOPED-COUNTRY AND AMERICAN EXPORTS, SELECTED YEARS

[NIC imports in millions of dollars]

	1960	1965	1970	1975	1978
Total imports:					
Brazil	1,462	1,096	2,849	13,592	15,054
Hong Kong	1,026	1,569	2,905	6,767	13,403
Korea	287	463	1,984	7,274	14,972
Singapore	1,332	1,244	2,461	8,133	13,049
Taiwan	297	558	1,528	5,960	11,051
Total	4,404	4,930	11,727	41,726	67,529
Imports from United States:					
Brazil	443	326	918	1,623	3,035
Hong Kong	126	174	406	1,734	3,764
Korea	118	182	637	1,586	4,087
Singapore	51	92	240	495	1,119
Taiwan	113	179	527	1,659	2,339
Total	851	953	2,728	7,097	14,344
Total United States exports	24,400	33,600	53,900	129,900	175,800

Note: The numbers for 1960 and 1965 for Singapore are those for Malaysia-Singapore.

Source: IMF, "Direction of Trade," various issues.

Relationship with Domestic Economic Growth

A satisfactory rate of growth of international trade is in the interest of the developed countries, including the United States as well as of the developing countries. In the absence of imports of labor-intensive products from developing countries, the growth rates of developed countries would be hampered, as they would have to continue pro-

ducing the labor-intensive products that run counter to their resource endowments.[25] There is a consistency of interests at this juncture.

It is in the interest of the NICs that developed countries' markets remain accessible and growing rapidly.

It is in the interest of other countries embarking upon export-oriented growth that the markets of both the NICs and the developed countries be open to them.

And it is in developed country interests that NIC markets, in addition to their own, be available to receive exports from other, less developed countries.

The NIC's, as was seen above, are already beginning to focus upon investments in somewhat more skill- and capital-intensive goods than was earlier the case, as their own real wage levels begin rising. If they gradually withdraw from the labor-intensive industries, as seems likely, reducing their exports to the developed countries and opening their markets to imports from labor-abundant countries, the degree to which the OECD countries will have further adjustment problems in labor-intensive goods will be reduced. There is, therefore, scope for a three-way, mutually-advantageous bargain in which all countries benefit from each other's liberal trade policies.

This immediately raises, of course, the question of adjustment assistance to American workers. There is ample evidence that the extent to which imports, as contrasted with economic growth, have adversely affected employment opportunities in American industries has been greatly exaggerated.[26] Productivity growth and shifting demand patterns as well as regional relocation of American industries, have played a bigger role than is generally recognized. Even in those industries in which imports have played a role, imports from developed, rather than developing countries have generally been a significant share of the total: focus upon imports from developing countries has been somewhat misplaced. And, it should not be forgotten that proceeds from our imports are used to purchase exports: if our imports are restricted to minimize dislocation, the export jobs that are lost, or fail to be created, are invisible, but nonetheless real.

The success of the NICs provides a lesson as to the importance of a free and growing international economy. While a strong case can be made for adjustment assistance in some form or other,[27] it seems clear that American economic growth and even more so, the growth prospects of developing countries are closely related to the maintenance of a healthy and open international trading order. While individual cases call for individual attention, to focus on restrictive measures as a general solution to adjustment problems would be to pay a high domestic price and to impose high costs on the rest of the world, in return for temporary relief of uncertain value to a relatively small group of American workers.

[25] American export industries generally have wage levels considerably above import-competing industries. This is a reflection of the fact that American exports of manufactures are considerably more skill-intensive than are import-competing industries. Thus, if resources could not be shifted as rapidly from low-skill, labor-intensive industries to skill-intensive industries, the rate at which real wages could increase would be lower.

[26] See Anne O. Krueger, "Labor Displacement and Economic Redevelopment in the United States," Journal of Policy Modeling, 2 (2), 1980.

[27] See James Cassing, "Alternatives to Protectionism," in Western Economies in Transition, I. Leveson and J. W. Wheeler, eds., Westview Press, 1980.